Euro wrap-up

Overview

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- Bunds made modest losses as euro area inflation exceeded expectations in May, with the services component up to a seven-month high.
- Gilts followed USTs higher while BoE data reported a marked slowdown in consumer credit growth but a pickup in mortgage lending.
- All eyes in the coming week will be on Thursday's ECB monetary policy announcement, where the Governing Council will cut rates by 25bps but will likely revise higher its near-term inflation projection.

Daily bond market movements

Bond	Yield	Change
BKO 2.9 06/26	3.085	+0.016
OBL 2.1 04/29	2.700	+0.015
DBR 2.2 02/34	2.658	+0.007
UKT 0⅛ 01/26	4.355	-0.090
UKT 0½ 01/29	4.198	-0.032
UKT 4⅝ 01/34	4.311	-0.033

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

Euro area

Inflation exceeds expectations with pickup driven by all-important services component

Ahead of the ECB's monetary policy announcement on 6 June, the flash euro area inflation figures for May exceeded expectations. The headline rate rose 0.2ppt from April to 2.6%Y/Y, 0.1ppt above the consensus on the Bloomberg survey. And probably of greater importance, the core rate (excluding energy, food, alcohol and tobacco) also increased by 0.2ppt, to 2.9%Y/Y, which contrasted with the consensus forecast of no change. The main cause of higher inflation was the services component, which rose 0.4ppt to a seven-month high of 4.1%Y/Y. In part, that reflected a significant base effect associated with the introduction a year ago of the German discounted public transport ticket. There was also probably additional upwards pressure from one-offs in typically volatile services items such as package holidays as well as a reversal of the impacts related to the timing of Easter. But at least until the full detail are published in a few weeks' time, the ECB hawks will remain concerned about more generalised persistence in the services component related to elevated wage growth. Indeed, according to the ECB's own seasonally adjusted estimates, services prices rose a strong 0.5%M/M for the third month out of the past four, pointing to the strongest momentum in that component (5.3%3M/3M annualised) in a year.

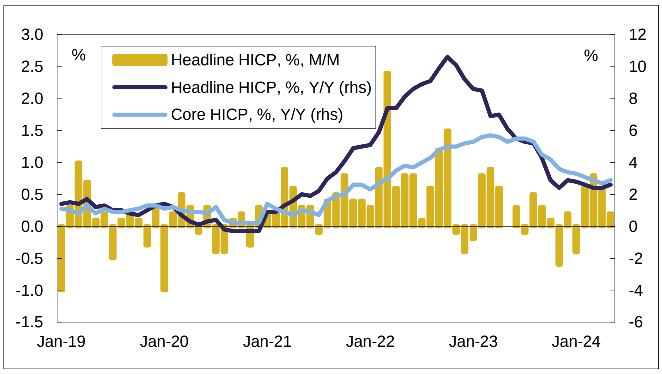
Energy inflation up on base effects, but minimal momentum in other goods components

The other major component to contribute to the rise in inflation in May was energy. In part due to lower prices of auto fuel and heating oil, energy prices overall fell 1.2%M/M this month despite the further withdrawal of government support. However, given the sharper drop a year ago, energy inflation rose 0.9ppt to a 13-month high of 0.3%Y/Y. More happily, inflation of food, alcohol and tobacco reversed April's rise to fall back to 2.6%Y/Y, matching the lowest rate since November 2021. So, momentum in that category (0.7%3M/3M annualised) continues to fade. And a minimal rise in core goods prices pushed the respective annual rate down a further 0.1ppt to 0.8%Y/Y, the lowest since July 2021. While surveys suggest that disinflation in the factory sector might now have run its course, momentum in consumer core goods inflation is now negligible (0.2%3M/3M annualised).

Inflation should fall back in June but looks to be overshooting the ECB's March projection

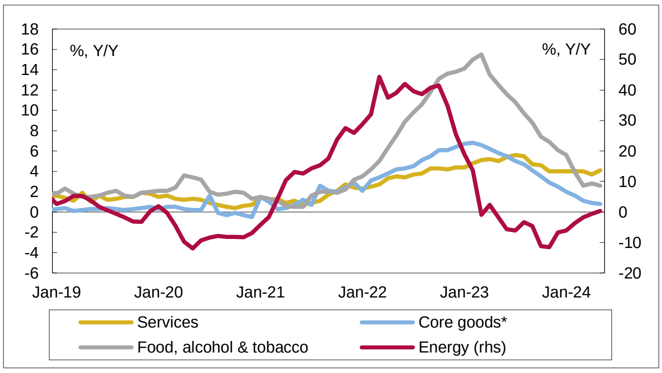
In part thanks to lower prices of auto fuel, we currently forecast headline inflation in June to reverse this month's 0.2ppt rise back to 2.4%Y/Y. And we expect the core rate to edge down 0.1ppt to 2.8%Y/Y. But that near-term trajectory would still leave both the headline and core rates above the ECB's projections for Q2, by 0.1ppt and 0.3ppt respectively. So, after inflation undershot the previous two sets of projections, an expected overshoot (albeit relatively modest one) of the March forecast will likely lead to an upwards revision of the price profile when the Eurosystem's updated projections are published in the

Euro area: HICP inflation



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Key HICP components



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

coming week. Indeed, given the respective cut-off dates used to determine the assumptions of certain market-based indicators used in its projections, the ECB will likely need to revise up its projection profile for energy inflation over coming quarters. More importantly, given the strength in the May data, and after negotiated wage growth picked up in Q1 while the unemployment rate unexpectedly fell in April to a new series low, the Eurosystem might be tempted to add extra persistence to the projection for services inflation. And after euro area economic growth in Q1 of 0.3%Q/Q also exceeded the ECB's expectation by some 0.2ppt., it will also likely revise up the expected profile for GDP in 2024 (with growth currently projected at 0.6%Y/Y). The need for all of those upwards revisions might well diminish somewhat the confidence of some hawkish members of the Governing Council in the outlook, contributing to a more risk averse approach to interest rate decisions than would otherwise have been the case.

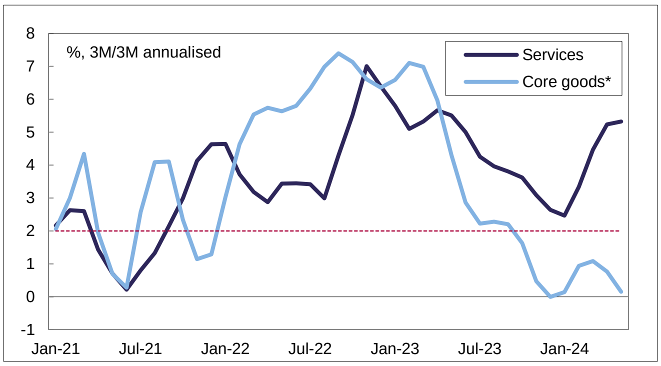
Updated projections to continue to suggest return of inflation to target in H225

Despite the upside surprise to GDP in Q1, economic growth was still below the ECB's estimate of potential. And surveys and hard data – such as today's soft figures for German retail sales and French goods consumption in April (see below) – imply that the pace of expansion remains below potential in the current quarter too. Survey indicators and vacancies also suggest that labour supply and demand are becoming better aligned. Inflation expectations remain well anchored. And so, consistent with certain wage trackers, and as noted by Chief Economist Lane in his FT interview this week, the ECB will continue to expect pay growth to moderate gradually over coming quarters and return to normal in 2026. Therefore, the Eurosystem's updated projections should remain consistent with a steady downtrend in services inflation. And they should also imply that headline and core inflation will likely return to the 2.0% target or below by the second half of 2025.

Inflation outlook still permits a first rate cut in June but second cut won't come before September

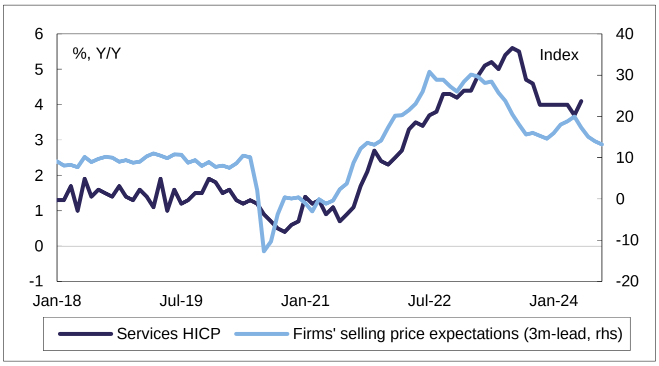
As such, the policymakers are still extremely likely to agree a first rate cut of 25bps on Thursday "to remove the top level of restriction". And a resumption of the downtrend in inflation would allow further rate cuts in future. However, the overshoot of the ECB's March projection means that the Governing Council will not approve a second interest rate cut before September. And the Governing Council's policy statement on Thursday will make clear that where policy goes then and thereafter will remain data dependent. It will also underscore that the stance will remain restrictive for a while yet. Only if disinflation – particularly in services – remains on track and consistent with its June projections meetings over coming months will rates will be cut for a second time in September. While we recognise the uncertainty of the outlook, for the time being we continue to expect ECB rate cuts of 25bps apiece in June, September and December, with further cuts to come – again probably once per quarter – in 2025.

Euro area: Core inflation momentum



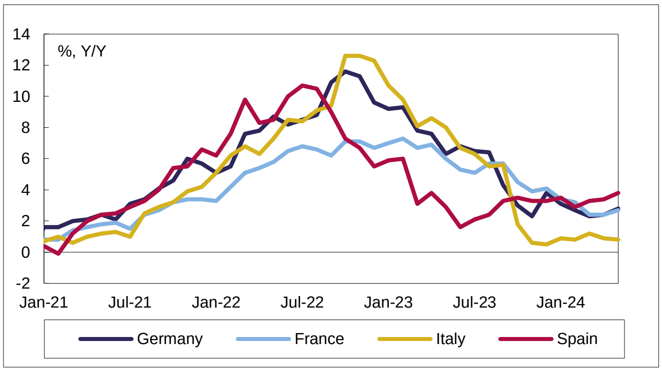
*Non-energy industrial goods. Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Services price indices



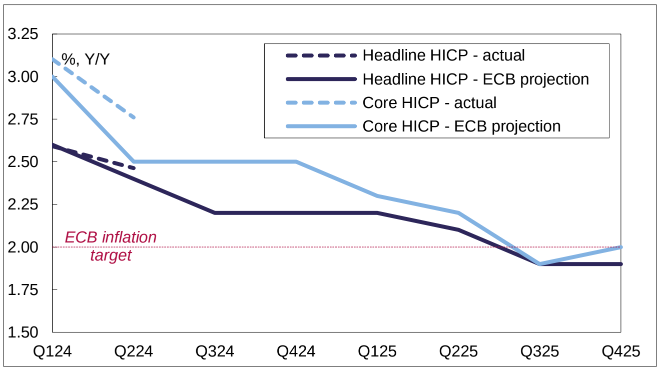
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: HICP inflation in selected member states



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: ECB inflation projection*



*Q224 figures based on April and May outturns. Source: Macrobond and Daiwa Capital Markets Europe Ltd.

The week ahead in the euro area

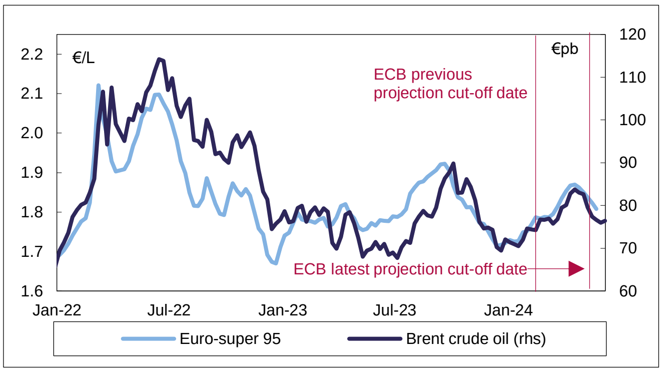
In addition to the ECB policy announcement, the coming week brings a handful of top-tier data releases, including euro area retail sales in April (Thursday) and the expenditure breakdown of GDP in Q1 (Friday) as well as German factory orders (Thursday) and industrial production (Friday) in April. Survey indicators due include the first release of the May construction PMIs (Thursday) and final manufacturing (Monday) and services PMIs (Wednesday).

While we expect household consumption to contribute positively to euro area GDP growth over Q2 as a whole, the April retail sales data will suggest a soft start to the quarter. Data released today reported a bigger-than-expected drop in German sales of 1.2%M/M that month to leave the level below the Q1 average, although sales growth in March was revised up by 0.8ppt to 2.6%M/M. In addition, French household consumption of goods fell 0.8%M/M in April more than fully reversing the revised 0.5%M/M increase in March. So, while Spanish retail sales rose last month, we expect to see a decline of about ½%M/M.

The third estimate of euro area GDP in Q1 should confirm growth of 0.3%Q/Q, which was the strongest in six quarters and 0.2ppt above the ECB's projection. The expenditure breakdown is likely to suggest that the expansion was relatively broad-based with support from several different components of final demand. We think that growth was firmest in fixed investment, not least however as mild winter weather supported a (likely temporary) surge in construction activity. In addition, with consumer confidence firming amid stronger real wage growth, household consumption likely grew, albeit modestly, for a fifth successive quarter. And growth in export volumes likely outpaced that in imports so that net trade also made a positive contribution. In contrast, we think that stock adjustments subtracted from GDP growth for a third successive quarter as firms looked to reduce excess inventory in the face of declining new orders.

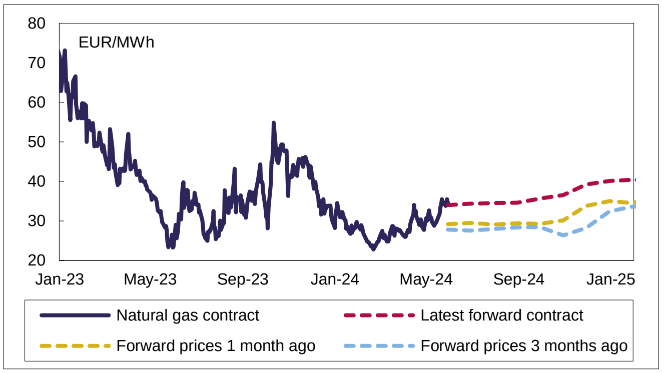
Following three successive monthly declines, we expect German factory orders to post growth of about ½%M/M in April. Leading indicators also point to a pickup in German manufacturing output that month following a drop of 0.4%M/M in March to maintain the recent uptrend in the sector. However, we see downside risks to overall German industrial production due to the likelihood of a pullback in construction following the weather-related surge of 3.9%Q/Q in that sector in Q1. Indeed, we expect the construction PMIs to remain consistent with a trend contraction in Germany and the euro area as a whole. But the final euro area services and manufacturing PMIs should align with the upbeat flash estimates, which were consistent with another quarter of GDP growth of 0.3%Q/Q. In particular, the euro area services activity index (53.3) was the best in 12 months while the manufacturing output index (49.6) was a 14-month high.

Euro area: Brent crude oil and petrol prices



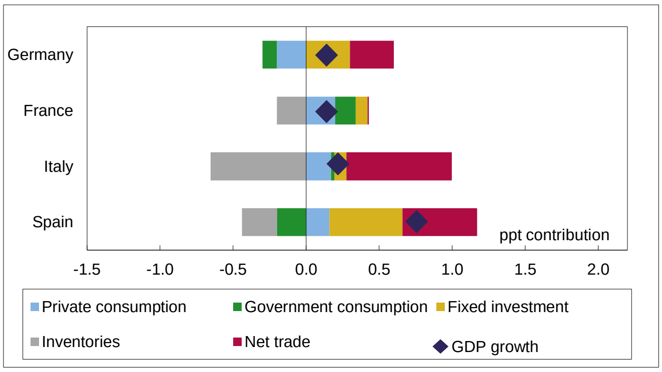
Source: Macrobond, Bloomberg and Daiwa Capital Markets Europe Ltd.

Euro area: Natural gas price



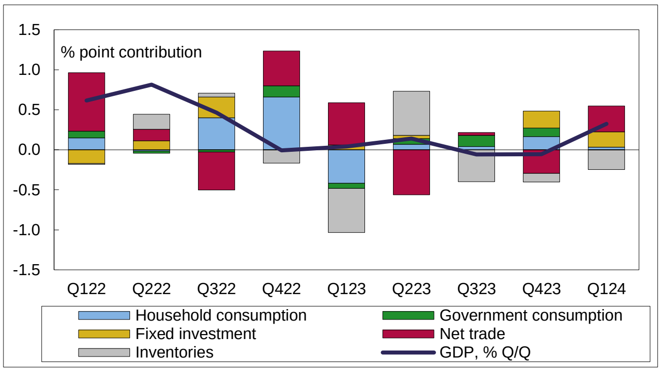
Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Euro area: Expenditure contributions to Q1 GDP



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Contributions to GDP growth*



**Q124 contributions are Daiwa forecasts. Source: Macrobond and Daiwa Capital Markets Europe Ltd.*

UK

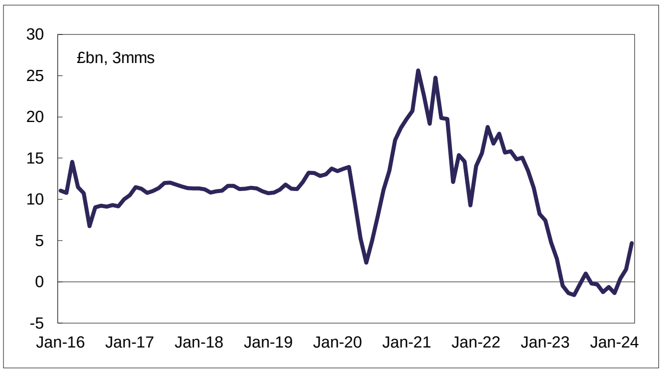
Mortgage lending the strongest since blow-out in interest rates in October 2022

The BoE's latest bank lending figures provided mixed messages. Consistent with the gradual turnaround in the housing market since last summer, decline in mortgage interest rates from last year's peak and rising households' disposable incomes, there was a notable pickup in mortgage lending at the start of Q2. In particular, net new secured lending of £2.4bn was the most since October 2022, shortly after the blow-out in interest rates under Liz Truss' short-lived and calamitous term as Prime Minister. However, this level remained some way below the pre-pandemic five-year average (£3.6bn). And given the lack of lending over the past year or so, annual growth in the stock of such loans remained very weak at just 0.2%Y/Y. Meanwhile, gross secured lending rose slightly on the month (£20.6bn) as repayments decreased but remained above the pre-pandemic average. While the effective interest rate paid on new mortgages was some 60bps below the November peak, shorter-dated mortgage rates have recently shifted higher as market expectations for the first cut in Bank Rate have been pushed back. Indeed, the average rate on a 2-year fixed mortgage with a loan-to-value ratio of 75% rose to 5% in April, some 25bps higher than in January. Against this backdrop, the number of mortgage approvals for house purchase moved broadly sideways last month, at 61.1k, with remortgaging approvals (29.9k) down to a five-month low. Admittedly, approvals for new purchases were still almost 20k above the average in 2023. And with today's Nationwide housing report suggesting that home prices rose 0.4%M/M in May, to be up a little more than 2% from last summer's trough, and consumer confidence on the rise, we expect mortgage lending to trend gradually higher over coming quarters.

Weak consumer credit and business lending might well limit near-term spending

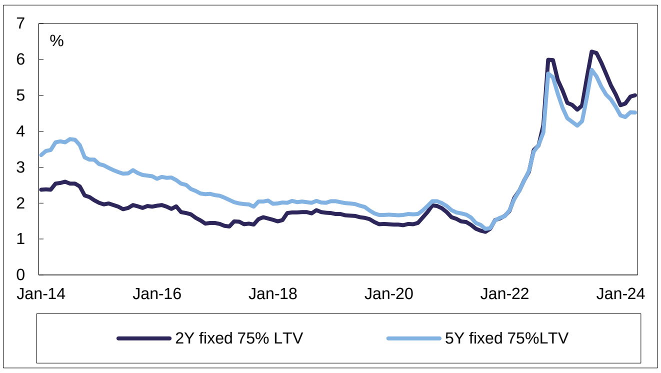
Contrasting markedly with the pickup in mortgage lending was a notable slowing in consumer credit growth. Net unsecured lending halved from March to just £0.7bn in April, the softest since November 2021, with net credit card lending (£0.2bn) the weakest for 16 months. Due to strong demand over recent years as the cost of living crisis peaked, annual growth in consumer credit remained elevated at 8.1%Y/Y, nevertheless the softest pace for seven months. The moderation might in part reflect the improvement in disposable incomes that month thanks in part to the double-digit rise in the National Living Wage and cut to household energy tariffs. But with households also depositing an additional £8.4bn with banks in April – the highest net inflow since September 2022 – and the largest net inflow into ISAs since the series began 25 years ago, today's data tally with the weakness in retail sales that month and might raise some concerns that household spending will remain relatively subdued over the near term. The ongoing decline in lending to businesses, which repaid a further net £1.1bn in April to leave the stock of such loans down 0.3%Y/Y, suggests that fixed investment growth might be restrained for a while too.

UK: Mortgage lending



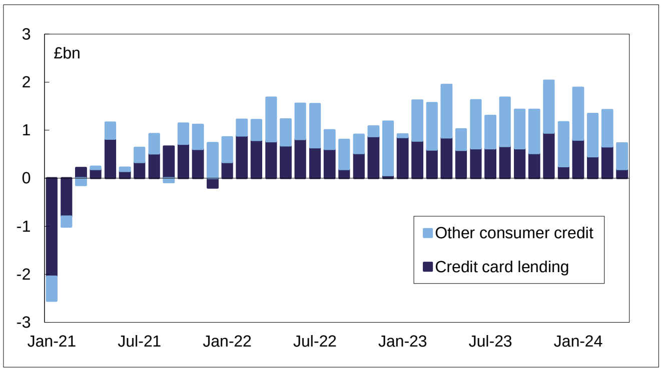
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Mortgage interest rates



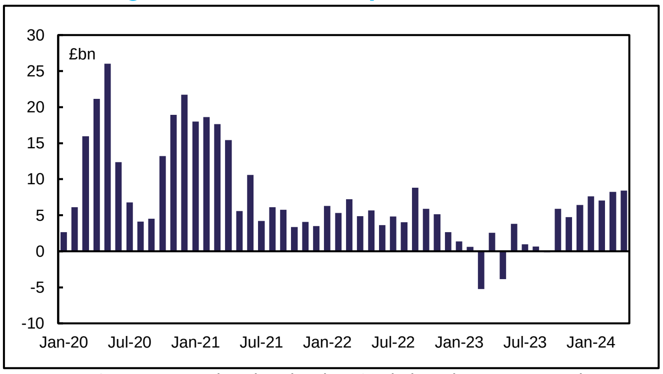
Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

UK: Unsecured lending to individuals



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Change in household deposits



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

The coming week in the UK

In an otherwise quiet week ahead for top-tier UK economic data releases, the results of the BoE's Decision Maker Panel survey for May on Thursday will be of most interest. In April, firms' selling price expectations for the twelve months ahead edged slightly higher to 4.2%Y/Y. But smoothing for monthly volatility, expected output price growth on a three-month basis eased to its softest for 2½ years as firms seemingly struggled to pass on additional costs to consumers. We expect firms' expectations for CPI inflation to remain well anchored in May after their forecast for three years ahead declined to just 2.6%Y/Y in April. Policymakers will also watch developments in wage expectations, which previously eased to a two-year low of 4.6%Y/Y, albeit remaining above levels consistent with the BoE's 2% inflation target over the medium term. Other surveys due in the coming week include the final manufacturing and services PMIs (Monday and Wednesday respectively), for which the flash releases implied a notable easing in price pressures in May but also a slowdown in growth momentum in the middle of Q2. The BRC's retail survey (Tuesday) and the construction PMIs (Thursday) for May are also due for release.

Daiwa economic forecasts

	2024				2025				
	Q1	Q2	Q3	Q4	Q1	Q2	2023	2024	2025
GDP	%, Q/Q						%, Y/Y		
Euro area	0.3	0.2	0.2	0.3	0.3	0.4	0.5	0.6	1.3
UK	0.6	0.3	0.3	0.2	0.2	0.3	0.1	0.7	1.0
Inflation, %, Y/Y									
Euro area									
Headline HICP	2.6	2.5	2.2	2.5	2.3	1.7	5.4	2.4	1.8
Core HICP	3.1	2.8	2.7	2.9	2.4	1.7	4.9	2.9	1.9
UK									
Headline CPI	3.5	2.1	2.2	2.8	2.4	2.0	7.3	2.7	2.1
Core CPI	4.6	3.5	3.2	3.2	2.7	1.7	6.2	3.6	1.9
Monetary policy, %									
ECB									
Deposit Rate	4.00	3.75	3.50	3.25	3.00	2.75	4.00	3.25	2.25
Refi Rate	4.50	4.25	3.65	3.40	3.15	2.90	4.50	3.40	2.40
BoE									
Bank Rate	5.25	5.25	5.00	4.75	4.50	4.25	5.25	4.75	3.75

Source: Bloomberg, ECB, BoE and Daiwa Capital Markets Europe Ltd.

The next edition of the Euro wrap-up will be published on date 4 June 2024

The coming week's data calendar

The coming few week's key data releases

Country		BST	Release	Period	Market consensus/ <u>*Daiwa forecast/actual*</u>	Previous
			Monday 3 June 2024			
Euro area		09.00	Final manufacturing PMI	May	47.4	45.7
Germany		08.55	Final manufacturing PMI	May	45.4	42.5
France		08.50	Final manufacturing PMI	May	46.7	45.3
		-	New car registrations* Y/Y%	May	-	10.9
Italy		08.45	Manufacturing PMI	May	47.9	47.3
		17.00	New car registrations Y/Y%	May	-	7.5
Spain		08.15	Manufacturing PMI	May	52.5	52.2
		-	New car registrations* Y/Y%	May	-	23.1
UK		09.30	Final manufacturing PMI	May	51.3	49.1
			Tuesday 4 June 2024			
Germany		08.55	Unemployment rate % (change 000s)	May	5.9 (8)	5.9 (10)
Spain		08.00	Unemployment (employment) change 000s	May	-	-60.5 (40.7)
UK		00.01	BRC retail monitor – like-for-like sales Y/Y%	May	1.2	-4.4
			Wednesday 5 June 2024			
Euro area		09.00	Final services (composite) PMI	May	53.3 (52.3)	53.3 (51.7)
		10.00	PPI Y/Y%	Apr	-5.3	-7.8
Germany		08.55	Final services (composite) PMI	May	53.9 (52.2)	53.2 (50.6)
		-	New car registrations* Y/Y%	May	-	19.8
France		07.45	Industrial production M/M% (Y/Y%)	Apr	0.5 (0.7)	-0.3 (0.7)
		08.50	Final services (composite) PMI	May	49.4 (49.1)	51.3 (50.5)
Italy		08.45	Services (composite) PMI	May	-	54.3 (52.6)
Spain		08.15	Services (composite) PMI	May	-	56.2 (55.7)
UK		09.30	New car registrations Y/Y%	May	-	1.0
		09.30	Final services (composite) PMI	May	52.9 (52.8)	55.0 (54.1)
			Thursday 6 June 2024			
Euro area		08.30	Construction PMI	May	-	41.9
		10.00	Retail sales M/M% (Y/Y%)	Apr	-0.4 (0.2)	0.8 (0.7)
		13.15	ECB deposit (refi) rate %	Jun	<u>*3.75 (4.25)*</u>	4.00 (4.50)
Germany		07.00	Factory orders M/M% (Y/Y%)	Apr	0.6 (0.3)	-0.4 (-1.9)
		08.30	Construction PMI	May	-	37.5
France		08.30	Construction PMI	May	-	41.6
Italy		08.30	Construction PMI	May	-	48.5
Spain		08.00	Industrial production M/M% (Y/Y%)	Apr	-	-0.7 (-1.2)
		08.00	House prices Q/Q% (Y/Y%)	Q1	-	-1.1 (4.2)
UK		09.30	DMP 3M output price (1Y CPI) expectations Y/Y%	May	3.9 (2.8)	4.0 (2.9)
		09.30	Construction PMI	May	-	53.0
			Friday 7 June 2024			
Euro area		10.00	GDP – 3rd estimate Q/Q% (Y/Y%)	Q1	<u>*0.3 (0.4)*</u>	-0.1 (0.1)
		10.00	Employment – 2nd estimate Q/Q% (Y/Y%)	Q1	<u>*0.3 (1.0)*</u>	0.3 (1.2)
Germany		07.00	Industrial production M/M% (Y/Y%)	Apr	0.2 (-3.1)	-0.4 (-3.3)
		07.00	Goods trade balance €bn	Apr	23.4	22.2
France		07.45	Trade balance €bn	Apr	-	-5.5

**Approximate date of release. Source: Bloomberg and Daiwa Capital Markets Europe Ltd.*

The coming week's key events & auctions

Country		BST	Event / Auction
Monday 3 June 2024			
- Nothing scheduled -			
Tuesday 4 June 2024			
Germany		10.30	Auction: €4.5bn of 2.9% 2026 bonds
UK		10.00	Auction: £2.0bn of 4% 2063 bonds
Wednesday 5 June 2024			
Germany		10.30	Auction: €3.0bn of 2.4% 2030 bonds
UK		10.00	Auction: £4.0bn of 3.75% 2027 bonds
Thursday 6 June 2024			
Euro area		13.15	ECB monetary policy announcement
		13.45	ECB President Lagarde to speak at post-meeting press conference
France		09.50	Auction: To sell bonds with various maturities
Spain		09.30	Auction: To sell bonds with various maturities
Friday 7 June 2024			
Euro area		09.00	ECB's Schnabel to speak in Berlin

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Friday's results

Economic data

Country		Release	Period	Actual	Market consensus/ *Daiwa forecast*	Previous	Revised
Euro area		Preliminary headline (core) HICP Y/Y%	May	**2.6 (2.9)**	*2.6 (2.7)*	2.4 (2.7)	-
Germany		Retail sales M/M% (Y/Y%)	Apr	**-1.2 (1.8)**	-	1.8 (-2.7)	2.6 (-1.9)
France		Preliminary HICP (CPI) Y/Y%	May	**2.7 (2.2)**	2.7 (2.4)	2.4 (2.2)	-
		PPI Y/Y%	Apr	**-6.8**	-	-7.5	-8.3
		Consumer spending M/M% (Y/Y%)	Apr	**-0.8 (0.2)**	0.2 (1.4)	0.4 (0.5)	0.5 (0.4)
		GDP – 2nd estimate Q/Q% (Y/Y%)	Q1	**0.2 (1.3)**	0.2 (1.1)	0.1 (0.8)	-
Italy		GDP – 2nd estimate Q/Q% (Y/Y%)	Q1	**0.3 (0.7)**	0.3 (0.6)	0.1 (0.7)	-
		Preliminary HICP (CPI) Y/Y%	Apr	**0.8 (0.8)**	0.8 (0.8)	0.9 (0.8)	-
UK		Lloyds business barometer (own price expectations)	May	**50 (61)**	-	42 (60)	-
		Nationwide house price index M/M% (Y/Y%)	May	**0.4 (1.3)**	0.1 (0.8)	-0.4 (0.6)	-
		Net consumer credit £bn (Y/Y%)	Apr	**0.7 (8.1)**	-	1.6 (8.8)	1.4 (8.7)
		Mortgage lending £bn (approvals 000s)	Apr	**2.4 (61.1)**	0.5 (61.5)	0.3 (61.3)	0.5 (-)

Auctions

Country	Auction
- Nothing to report -	

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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