Euro wrap-up

Overview

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- Bunds made losses as the ECB delivered the first rate cut this cycle, but made no watertight commitment to ease policy further as the Eurosystem revised up its inflation projection for this year and next.
- Shorter-dated Gilts made notable gains as the BoE's DMP survey signalled a further moderation in firms' inflation and wage expectations.
- Friday will bring updated estimates of euro area GDP, employment and employee compensation in Q1, as well as German industrial production data.

Daily bond market movements

Bond	Yield	Change
BKO 2.9 06/26	3.012	+0.039
OBL 2.1 04/29	2.602	+0.044
DBR 2.2 02/34	2.547	+0.042
UKT 0⅛ 01/26	4.285	-0.054
UKT 0½ 01/29	4.061	-0.028
UKT 4⅝ 01/34	4.172	-0.011

*Change from close as at 5:00pm BST.
Source: Bloomberg

Euro area

A relatively hawkish rate cut from the ECB with further easing in July seemingly all but ruled out

There were no surprises from the ECB's policy decisions today. As had been signalled well in advanced, and having held rates steady for nine months, the Governing Council eased policy by 25bps, taking the deposit rate down from its series high to 3.75%. All but one member agreed to the decision, with reports suggesting that uber-hawkish Austrian Governor Holzmann had voted against changing policy. In terms of forward guidance, also as expected, the Governing Council repeated that it will keep "policy rates sufficiently restrictive for as long as necessary", "will continue to follow a data-dependent and meeting-by-meeting approach", [and] "is not pre-committing to a particular rate path". Indeed, in her press conference, ECB President Lagarde emphasised that sufficient additional evidence, based on a wide range of different data, would be required to justify any further easing at a future meeting, thus seemingly downplaying the chances of a rate cut at the next meeting in July. The policy statement also gave no clear steer that today's decision was likely to represent the first of a series of rate cuts. And a Bloomberg report citing unnamed ECB officials issued following the press conference suggested that a July rate cut had been all but ruled out.

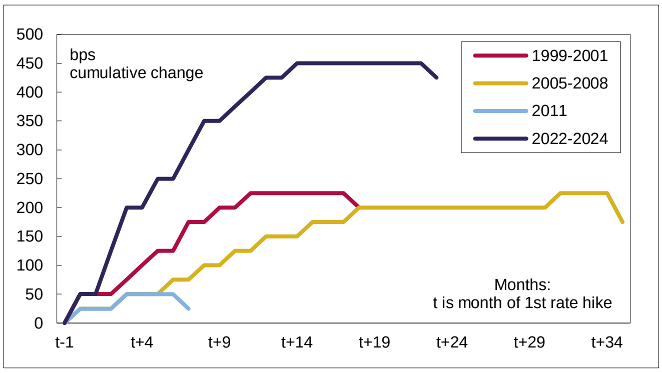
But Lagarde still notes "strong likelihood" that policy is in new easing phase

When asked explicitly in her press conference, Lagarde stated that she wouldn't confirm that the ECB was now in a new phase of dialling back restriction. However, she conceded that there was a "strong likelihood" that the ECB had indeed entered such a stage. Moreover, she insisted that policy was still restrictive, and "far away from a neutral rate", so the ECB had "a long way to go" before policy could be considered not to be restrictive. Moreover, she emphasised that, given the recent decline in inflation, policy would have become increasingly restrictive had rates not been cut today. In the round, therefore, we interpreted Lagarde's comments today to imply that the Governing Council still has a clear easing bias, with a further rate cut likely in September as long as there are no new surprises in the economic data between now and then.

Inflation outlook for 2024 and 2025 revised up but ECB still expects to hit target in 2026

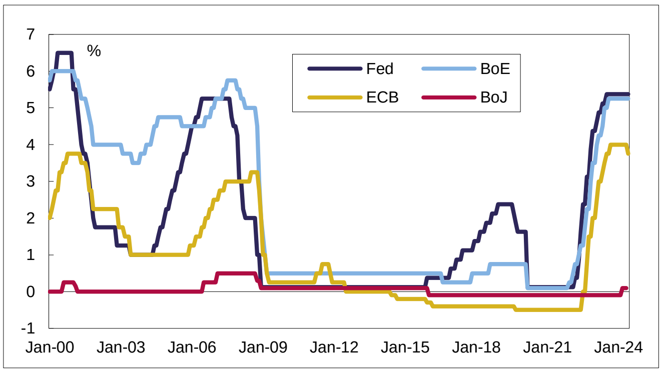
With the ECB having previously all but pre-committed to today's rate cut, in her press conference Lagarde appeared uncomfortable to justify it, as the Eurosystem staff simultaneously revised up the ECB's inflation projections for both 2024 and 2025. The upwards revisions principally reflected the upside surprises to inflation in April and May which revealed greater than expected stickiness in the services component, as well as the unanticipated pickup in negotiated wage growth in Q1. In particular, the forecasts for average headline inflation this year and next were revised up by 0.2ppt to 2.5%Y/Y and 2.2%Y/Y respectively. And those for core inflation were revised up by 0.2ppt and 0.1ppt to 2.8%Y/Y and 2.2%Y/Y. Moreover,

ECB: Rate hike cycles compared



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Major central bank interest rates



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

while inflation persistence is still expected to fade gradually, the date at which headline inflation is projected to return back to the 2.0%Y/Y target was put back by two quarters to Q126. Nevertheless, the projections for both headline and core inflation in 2026 were both left unchanged at 1.9%Y/Y and 2.0%Y/Y respectively, with those figures deemed consistent with a rate cut today in part as the Governing Council's confidence in its forecasting abilities has increased.

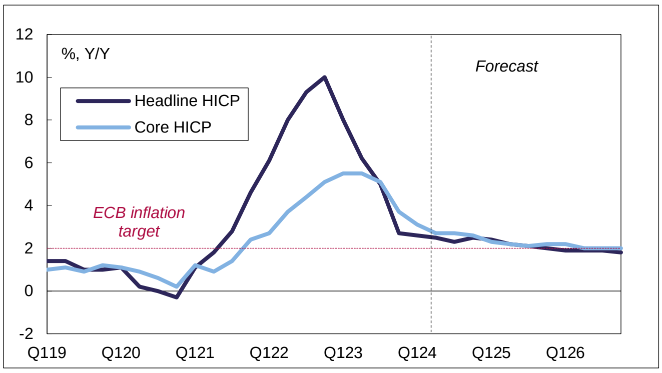
GDP growth outlook revised up this year with offsetting downwards revision next year

Just as the Eurosystem staff revised up their near-term inflation outlook, they were also more upbeat about the prospects for euro area GDP growth this year. Indeed, reflecting both the upwards surprise to economic output in Q1, as well as information about developments in the current quarter, the staff now expect GDP to rise 0.4%Q/Q between Q2 and Q4, before growth moderates to 0.3%Q/Q in H125. As before, growth should be led by household consumption on the back of higher real wages, with exports also expected to provide support, while the drag from high interest rates – not least on capex – is expected to fade gradually. As a result, GDP is projected to rise 0.9%Y/Y this year, 0.3ppt more than previously anticipated, with growth in 2025 nudged down by 0.1ppt to 1.4%Y/Y, before a reacceleration to 1.6%Y/Y in 2026. Should the ECB feel the need to revise up that growth projection further over coming quarters – which could push it materially above reasonable estimates of potential – the case for further easing would significantly diminish. However, we think that growth in Q2 will fall short of the ECB's new forecast, not least given the risks of adverse payback for some of the temporary factors – such as the weather-induced surge in construction – which boosted growth in Q1. And so, we maintain our baseline forecast that the ECB will cut rates by 25bps in each quarter between now and the end of 2025.

Retail sales start Q2 in reverse to extend soft trend

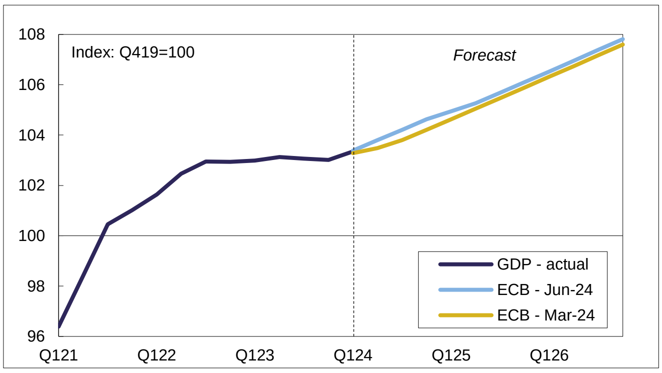
Today's data suggested that growth in Q2 will be no better than in the first quarter. While household consumption likely made a positive contribution to euro area GDP growth in Q1, that increase would have been driven by services while spending on goods was subdued. Indeed, retail sales volumes were unchanged in Q1 from Q4. And their underwhelming trend extended into Q2, with sales dropping 0.5%M/M in April to remain flat on a three-month basis and also merely in line with the level a year earlier. Weakness at the start of the quarter was most acute in sales at auto fuel stores, which fell a steep 2.2%M/M due to sharp increases in petrol prices that month. Food sales also fell, although the drop of 0.5%M/M left them up 0.2%3M/3M. And core sales (i.e. those of non-food, non-fuel items) rose a minimal 0.1%M/M to be up 0.3%3M/3M. With lower petrol prices, sales at auto fuel stores are likely to have rebounded in May. And with real incomes rising and unemployment at a series low, we expect core sales to maintain a very modestly positive trend over the remainder of the quarter. Nevertheless, while consumer confidence last month rose to the highest level since Russia's invasion of Ukraine, households continue to report a reluctance to make major purchases. And retail sales growth over Q2 as a whole will likely be minimal at best.

Euro area: ECB inflation projection



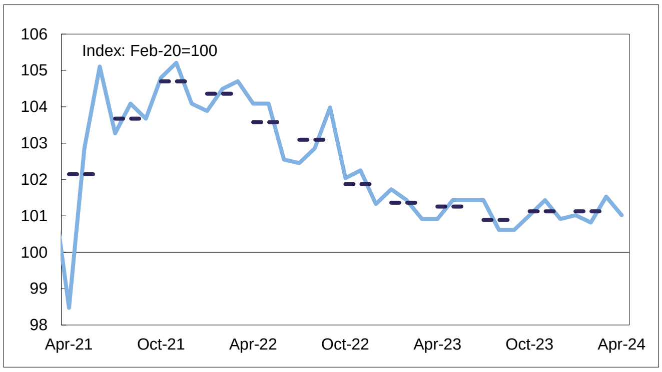
Source: ECB, Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: ECB growth projection



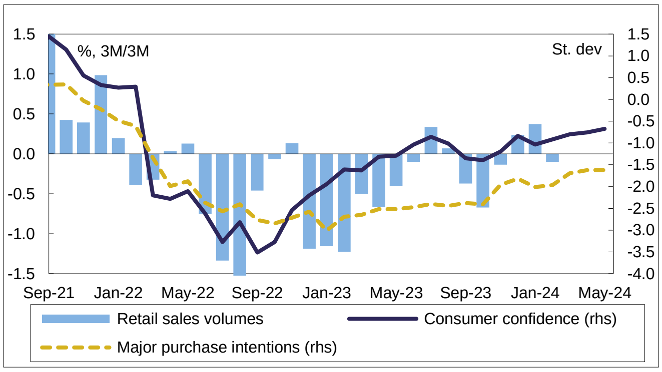
Source: ECB, Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Retail sales level*



**Dashed dark blue line represent quarterly averages. Source: Macrobond and Daiwa Capital Markets Europe Ltd.*

Euro area: Retail sales & consumer confidence



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

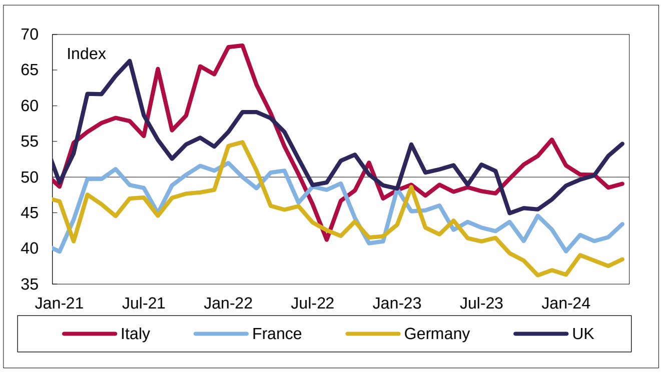
May PMIs reinforce expectations of a drop in construction output in Q2

Like household consumption, construction investment also likely provided support to euro area GDP growth in Q1. However, in large part that reflected the exceptionally mild weather at the start of the year without which activity would have been much weaker. Indeed, not least given the impact of past monetary tightening on the housing market, underlying momentum in construction remains subdued, pointing to adverse payback this quarter for the strength in Q1. Admittedly, today's results showed a 1.0pt rise in the headline euro area construction activity PMI in May. But at 42.9, it remained firmly below the long-run average and consistent with a contraction trend. The housebuilding index remained very low by historical standards (36.7), with the indices for commercial work and civil engineering suggestive of more modest declines in output. More happily, expectations for the coming year were the least negative in more than two years, implying that firms expect the sector to turn gradually for the better over coming quarters if and when the ECB gradually eases policy further. Among the member states, the German (38.5) and French (43.4) construction PMIs rose to the highest levels since February and November respectively but were similarly still consistent with significant falls in activity. In Italy, where construction output has been a significant source of growth over recent years, the equivalent index (49.0) edged up from April's eight-month low but was also suggestive of a dip in output this quarter, likely due to the reduction in government support for energy-efficient building renovations (the so-called Superbonus scheme).

German factory orders disappoint in April, but core orders suggest downturn has bottomed

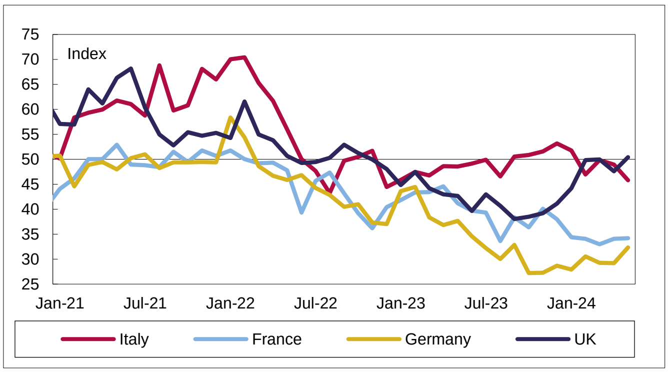
Following the recent improvement in German manufacturing sentiment indicators – including the PMIs and ifo business indices – and coming on the back of three consecutive declines since the start of the year, the further fall in German factory orders at the start of Q2 reported today was disappointing. Admittedly, the drop in total new orders in April was modest at just 0.2%M/M. But this left them down some 5½%3M/3M – the steepest such drop since October 2021 – and at the lowest level since the first Covid-19 lockdown and the euro crisis before that. The weakness in part reflected large-scale orders, which had a notable impact on the 'other transport equipment' subsector (-15.4%M/M) related to aircraft, ships and rail, as well as electronics (-5.1%M/M), and machinery and equipment (-1.5%M/M). In contrast, new auto sector orders rose for the third month out of the past four (4.1%M/M). When excluding major items, core orders increased for the first month in four, and by a sizeable 2.9%M/M – the most in eleven months – thanks to a strong rebound in capital (5.2%M/M) and non-durable consumer goods orders (4.0%M/M). And while this left core orders on a three-month basis down 1.3%3M/3M, today's figures support the view that the German manufacturing downturn might have bottomed. This would tally with the latest manufacturing new orders PMI, which jumped more than 6pts in May to its highest level (46.6) for more than two years, while the output index rose for a third month in May to the highest for 13 months. This notwithstanding, today's manufacturing

Europe: Construction activity PMIs*



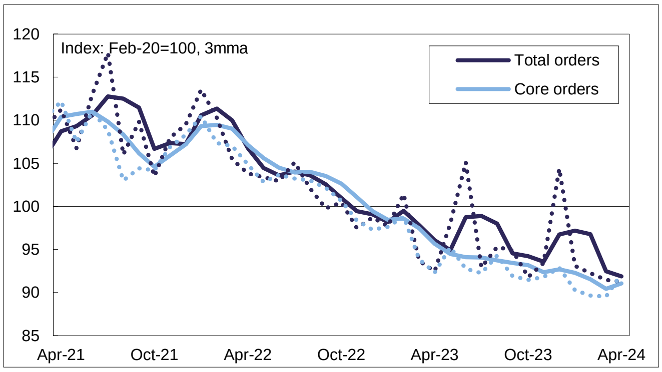
Source: Macrobond, S&P Global and Daiwa Capital Markets Europe Ltd.

Europe: House building PMIs



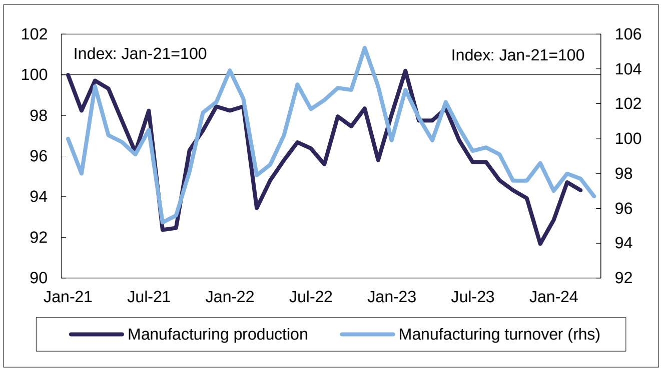
Source: Macrobond, S&P Global and Daiwa Capital Markets Europe Ltd.

Germany: Factory orders*



**Core orders exclude major orders. Dotted lines represent unsmoothed data*
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Germany: Manufacturing production & turnover



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

turnover figures disappointed, declining for a third month in four and by 0.9%M/M, suggesting some downside risks to tomorrow's manufacturing production data.

The day ahead in the euro area

In the euro area, the third estimate of Q1 GDP – due tomorrow – should confirm growth of 0.3%Q/Q, the strongest in six quarters. The expenditure breakdown will suggest that the expansion was relatively broad-based, but firmest in fixed investment, not least as mild winter weather supported a (likely temporary) surge in construction activity. Consumption likely grew for a fifth successive quarter. And growth in export volumes likely outpaced that in imports. In contrast, we think that stock adjustments subtracted from GDP growth for a third successive quarter as firms reduced excess inventory due to declining new orders. This release will also bring updated employment numbers, as well as important estimates of employee compensation in Q1. Meanwhile, German industrial production figures for April are also due. Leading indicators point to a pickup in manufacturing output that month following a drop of 0.4%M/M in March. However, today's manufacturing turnover figures reported a decline of 0.9%M/M. And while those data haven't provided the best guide to manufacturing output over recent months, we see downside risks to overall German IP also due to the likelihood of a pullback in construction following the weather-related surge of 3.9%Q/Q in that sector in Q1. German goods trade figures for April are also due.

UK

BoE survey signals a further moderation of business wage and price expectations

Given the upside surprise to inflation in May, persistent stickiness in services, strong pay growth and the general election on 4 July, the first rate cut from the BoE this cycle seems highly unlikely to come before the MPC's 1 August meeting when it will have a fresh set of projections to guide its decision. Nevertheless, tallying with the moderation in price pressures implied in the PMI surveys, the BoE's latest Decision Maker Panel survey results reported a further easing of business inflation and wage growth expectations in May. In particular, having picked up in April – perhaps reflecting higher costs amid the rise in the National Living Wage that month – firms' expected selling-price growth over the coming twelve months fell 0.4ppt to 3.8%Y/Y, with the three-month rate (3.9%3M/Y) down to its lowest since September 2021. On a three-month basis, firms' expectation for CPI inflation twelve months ahead dropped by 0.1ppt 3.0%3M/Y, the lowest on the admittedly short series. And while the expectation for three years ahead moved sideways at 2.7%3M/Y, this too was the lowest in two years and 1.7ppts below the peak. Meanwhile, firms' expectation for wage growth over the coming twelve months dropped a further 0.3ppt to 4.5%3M/Y, the lowest since June 2022, with the single-month rate down 0.5ppt to 4.1%Y/Y, some 2.0ppts below their realised wage growth over the past year and 2.2ppts below the peak in December 2022.

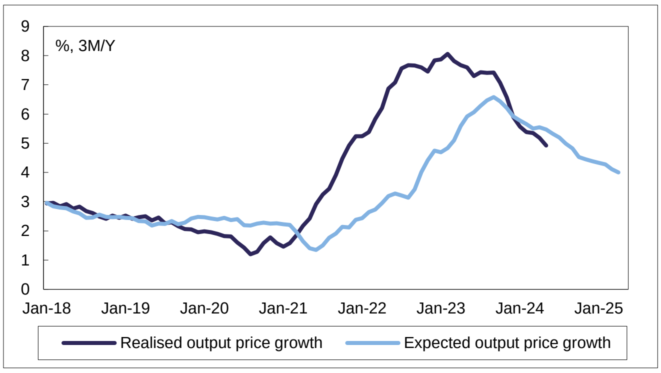
Construction PMI signals the strongest growth in two years

Contrasting the implied slowdown in services activity but echoing greater optimism among manufacturers, today's construction PMIs signalled accelerated growth in the sector in the middle of Q2. In particular, the headline activity index rose for a sixth successive month in May, by 1.7pts to 54.7, a two-year high, to leave it trending some 4.3pts above the Q1 average. And for the first time in two years, all three sub-sector components implied positive growth in May, with commercial activity (55.9) underpinning the expansion, while house building (50.4) recorded the first above-50 reading since October 2022. Meanwhile, firms reported the strongest growth in new orders in twelve months, which led to a renewed increase in purchasing activity following eight months of decline and the largest increase in headcount since September. And given improved supply-chain conditions, firms signalled a further moderation in input costs.

The day ahead in the UK

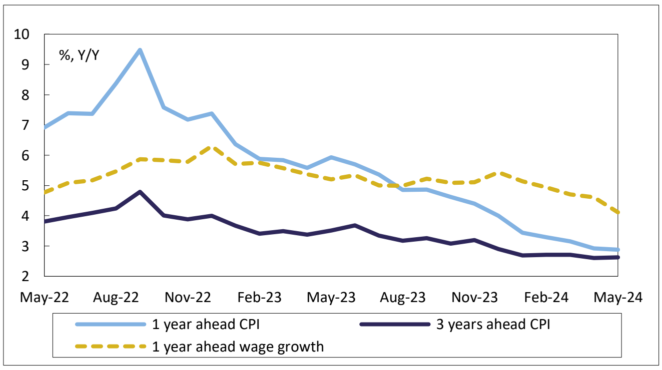
It should be a quiet end to the week for UK economic news, with no top-tier releases due.

UK: Firms' output price expectations



Source: BoE DMP survey, Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Firms' CPI & wage expectations



Source: BoE DMP survey, Macrobond 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		Construction PMI	May	**42.9**	-	41.9	-
		Retail sales M/M% (Y/Y%)	Apr	**-0.5 (0.0)**	-0.4 (0.2)	0.8 (0.7)	0.7 (-)
		ECB deposit (refi) rate %	Jun	**3.75 (4.25)**	*3.75 (4.25)*	4.00 (4.50)	-
Germany		Factory orders M/M% (Y/Y%)	Apr	**-0.2 (-1.6)**	0.6 (0.3)	-0.4 (-1.9)	-0.8 (-2.4)
		Construction PMI	May	**38.5**	-	37.5	-
France		Construction PMI	May	**43.4**	-	41.6	-
Italy		Construction PMI	May	**49.0**	-	48.5	-
Spain		Industrial production M/M% (Y/Y%)	Apr	**0.3 (0.8)**	-	-0.7 (-1.2)	- (-1.3)
		House prices Q/Q% (Y/Y%)	Q1	**2.6 (6.3)**	-	-1.1 (4.2)	-
UK		DMP output price (CPI) expectations 1Y ahead 3M/Y% (Y/Y%)	May	**3.9 (2.9)**	3.9 (2.8)	4.0 (2.9)	-
		Construction PMI	May	**54.7**	-	53.0	-
Auctions							
Country		Auction					
France		sold €7.17bn of 3% 2034 bonds at an average yield of 3.05%					
		sold €2.87bn of 1.25% 2038 bonds at an average yield of 3.21%					
		sold €1.96bn of 3.25% 2055 bonds at an average yield of 3.46%					
Spain		sold €1.98bn of 2.5% 2027 bonds at an average yield of 3.039%					
		sold €2.00bn of 0.01% 2031 bonds at an average yield of 3.003%					
		sold €1.88bn of 4% 2054 bonds at an average yield of 3.853%					
		sold €510mn of 2.05% 2039 index-linked bonds at an average yield of 1.392%					

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	GDP – 3rd estimate Q/Q% (Y/Y%)	Q1	*0.3 (0.4)*	-0.1 (0.1)
		10.00	Employment – 2nd estimate Q/Q% (Y/Y%)	Q1	*0.3 (1.0)*	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
Auctions and events						
Euro area		09.00	ECB's Schnabel to speak in Berlin			

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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