Euro wrap-up

Overview

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- Bunds made gains while French and Italian spreads widened further as concerns about the possible consequences of the forthcoming French election intensified.
- Gilts made gains as the UK's unemployment rate rose to a 2½-year high and private regular pay growth moderated to a 2-year low.
- Wednesday will bring the detailed breakdown of German inflation in May, as well as UK GDP data for April.

Daily bond market movements

Bond	Yield	Change
BKO 2.9 06/26	3.016	-0.065
OBL 2.1 04/29	2.646	-0.059
DBR 2.2 02/34	2.621	-0.048
UKT 0⅛ 01/26	4.314	-0.061
UKT 0½ 01/29	4.140	-0.055
UKT 4⅝ 01/34	4.266	-0.054

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

Euro area

French political uncertainty significantly clouds the outlook

Once again, political developments have upset Europe's financial markets. While the broad shape of the European Parliament (EP) election result was in line with expectations, the consequences in France, where President Macron's party (Renaissance) fared particularly badly at the expense of the far-right, risk being profound. Indeed, after Marine Le Pen's Rassemblement National (RN) won more than twice the number of votes of his own party, Macron's unexpected decision to dissolve the lower house of the French national assembly and call a snap general election has raised big uncertainty over the policy direction of France – and given its major importance in the bloc – the EU as a whole. So, a sell-off in OATs, BTPs and other Southern European government bonds, and a hit to regional equities, not least bank stocks, and the euro exchange rate, is not entirely unjustified.

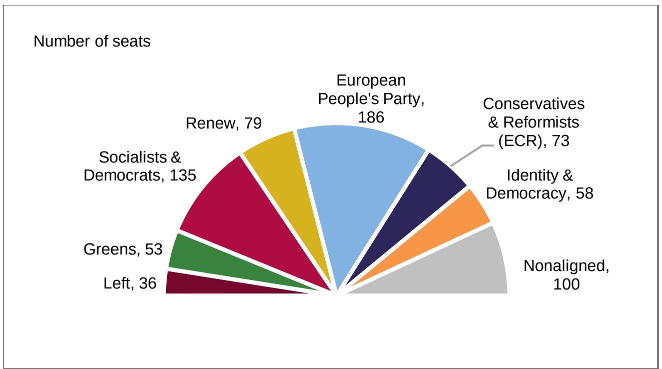
EP election result need not have upset investors

At the aggregate level, the European Parliament election result would not have triggered market volatility. The establishment centre-right European Peoples Party EPP group increased its share of seats to more than 25% of the total. The similarly establishment centre-left Socialists and Democrats SD group lost just a few seats overall to remain comfortably the second largest grouping (about 19%). And while the centrists (Renew, which includes Macron's party) as well as the Greens were the big losers, the EPP, SPD and Renew together retained a majority, which should have been consistent with broad continuity of policy at the EU level. Moreover, while in aggregate they increased their share of EP seats to about one quarter, Europe's far-right parties are heterogeneous and relatively divided, limiting their scope to disrupt EU policymaking. For example, Meloni's Brothers of Italy would want to continue to support EU policies, including additional common borrowing, that maintain large funding flows from Brussels to Rome. At the margin, the new EP might have meant that future EU policies could be somewhat less green. Controls on immigration, etc. would inevitably have taken a higher profile. And despite the better showing of her EPP group, Von Der Leyen would still not be assured to win the Parliament's endorsement for a second term as Commission President. Without the events in France, however, investors might barely have paid attention.

Macron hopes to focus electorate's minds on possible consequences of Le Pen

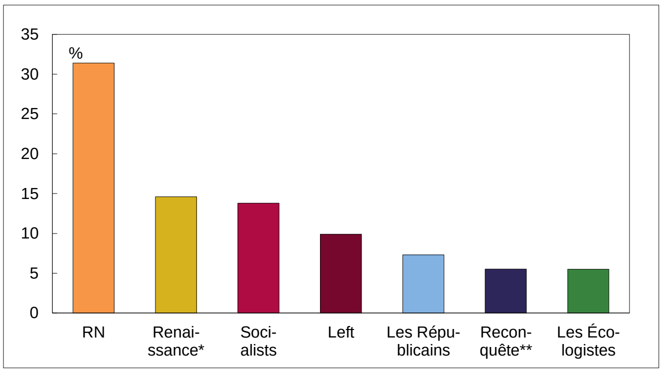
Macron's decision to call a snap French general election has injected much greater risk into the outlook for French and EU policy. Admittedly, the lack of majority for his government in the lower house had already raised the likelihood that the French government would fail this year to pass substantive legislation, including a new Budget. With the underlying health of the French public finances having recently deteriorated, resulting in a credit rating downgrade by S&P at the end of last month,

Euro area: European Parliament election results



Source: Politico and Daiwa Capital Markets Europe Ltd.

France: European Parliament vote share



**Includes other Renew affiliated parties. **Includes other ECR affiliated parties.*
Source: Politico and Daiwa Capital Markets Europe Ltd.

paralysis in policymaking would have been inconsistent with stability, whether fiscal or political. So, an early election before year-end was not an unreasonable bet. By calling that election now, Macron might have hoped to give the impression of being in control of events. And he appears keen to test the true strength of support for the far right. He will count on the election campaign providing greater scrutiny of the populists' policy platform, which he will note is incoherent. He will also thus expect to focus the minds of the electorate more tightly on the potentially damaging consequences of an RN-led government for France and its citizens. And he will anticipate that the two-stage process that governs elections to the lower house will reduce the influence of protest votes in the outcome. Certainly, he would have hoped that a broad front of establishment parties – ranging from centre-left to centre-right – would have combined to defeat the populists. And even if the election was to result in another hung parliament, he would have hoped that an establishment coalition would eventually emerge from the subsequent negotiations.

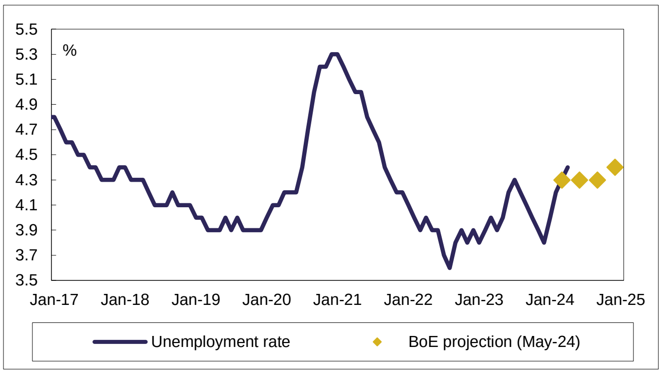
Leader of centre-right Les Républicains considers collaboration with the far-right

However, as illustrated by the UK's Brexit referendum in 2016, high-stakes plebiscites that force voters to choose between the status quo and an ill-defined or incoherent radical alternative can still sometimes unwittingly lead to the disruptive outcome. Certainly, opinion polls make clear that Macron and his party remain unpopular. Moreover, some elements of the main centre-right party, Les Républicains, including leader Eric Ciotti, are reportedly considering collaboration with RN, while the centre-left Socialists are considering coordination with the populist left-wing parties. So, his hopes of creating a successful united front against the far right already risks unravelling.

An RN-led French government could have profound implications for EU as well as France

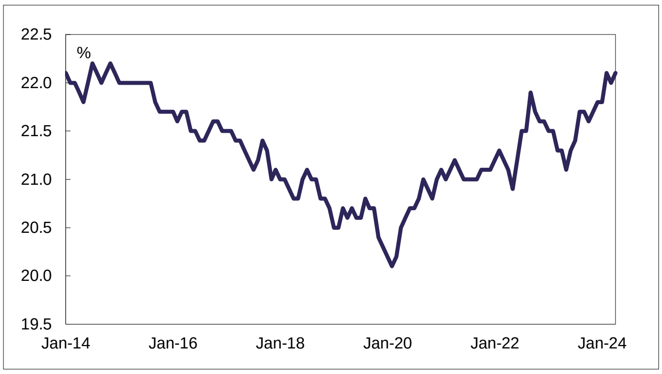
Importantly, with polls suggesting that the RN is on track to be the largest single party in the French lower house, a right-wing or exclusively far-right government led by her party's president Jordan Bardella might currently appear just as, if not more likely an outcome than a coalition (or minority) government led by Macron's allies. While such a government might ultimately be short-lived, until it is dissolved it might result in no less policy paralysis than the status quo, with even more profound consequences if it is able to pass legislation. Certainly, with Le Pen having previously threatened to withhold some of France's contribution to the EU budget, been no fan of fiscal transfers to Southern Europe, and criticised French and EU support for Ukraine, the next French assembly might represent a roadblock to constructive policymaking at the EU level. Joint EU borrowing to finance a common defence and security policy, which is set to be discussed for the first time by EU leaders at a summit at the end of the month and had seemed likely to be a priority of the next European Commission, might be an eventual non-runner. And, ultimately it is questionable whether Macron – who up to now has given greater

UK: Unemployment rate



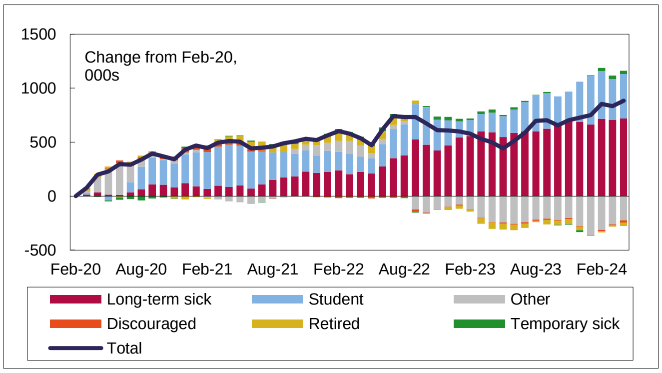
Source: BoE, Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Inactivity rate



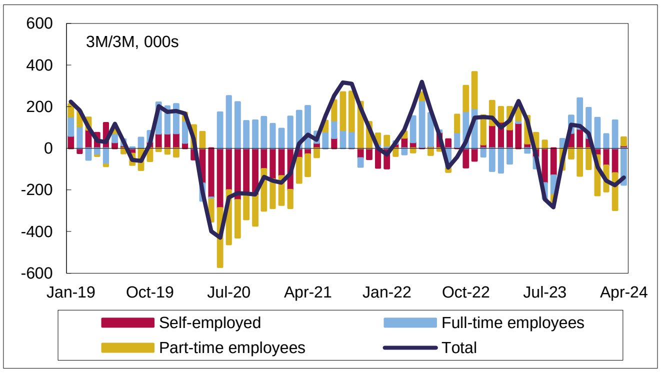
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Reasons for inactivity



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Change in employment



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

strategic leadership to policymaking in the EU than any other leader – could tolerate the loss of face from lame-duck cohabitation with the Putin-sympathiser Le Pen and her side-kick Bardella.

Macron's own future in doubt if his gamble goes wrong

So, just as former Cameron's term as UK PM came to an early end after his Brexit gamble failed, the President's own future would seem in doubt if his decision to call a snap election backfired. A premature end to Macron's term – which is not due to conclude until 2027 – would seem a feasible consequence. And even if the legislative paralysis meant that a far-right government was short-lived and Macron could withstand the significant loss of face in the interim, the possibility that the electorate would be prepared to give a stronger mandate to the far right at a subsequent national assembly election, and/or the next Presidential election, should certainly not be dismissed.

The day ahead in the euro area

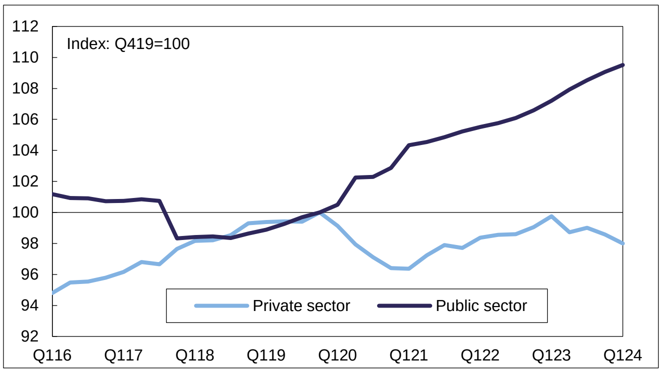
Tomorrow will be another relatively quiet day for euro area data will bring just the final figures for German inflation in May, which will provide more granular detail. The flash estimates saw the EU harmonized HICP rate jump 0.4ppt to 2.8%Y/Y, while the national CPI measure rose 0.2ppt to 2.4%Y/Y. The pickup principally reflected higher services inflation (up 0.6ppt to a seven-month high of 3.9%Y/Y), which tomorrow's detail will likely confirm largely reflected base effects associated with the introduction last May of a discounted travel pass. In contrast, core goods inflation fell to the lowest in more than two years, while food inflation remained very weak at less than 1%Y/Y and energy inflation stayed in negative territory.

UK

Unemployment rate rises to 2½-year high despite a further drop in the labour force

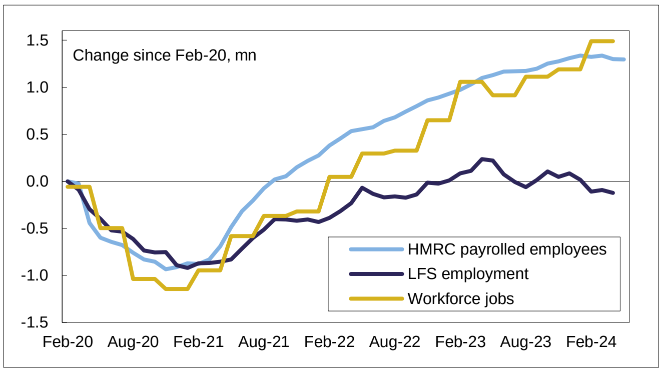
Today's UK labour market data were again a mixed bag. Nevertheless, despite the pickup in economic activity over the first quarter and signs of ongoing growth in Q2, they offered evidence of a further loosening in the labour market at the start of the second quarter. Indeed, according to the ONS's Labour Force Survey (LFS), joblessness rose 138k in the three months to April to 1.51mn, the highest level since August 2021 and some 109k above the pre-pandemic benchmark in February 2020. As such, the unemployment rate unexpectedly rose for a fourth consecutive month in April, to 4.4%, 0.1ppt above the BoE's projection for Q2, 0.6ppt above December's recent low and the highest level in over 2½% years. Admittedly, the unemployment rate remains slightly below the BoE's estimate of the equilibrium rate (4½%), suggesting that the labour market remains relatively tight. Of course, the extent of labour market tightness in part reflects persisting supply-side

UK: Private & public sector employment



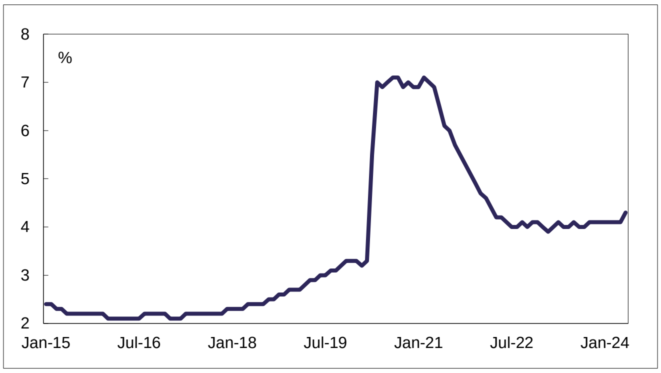
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Measures of employment*



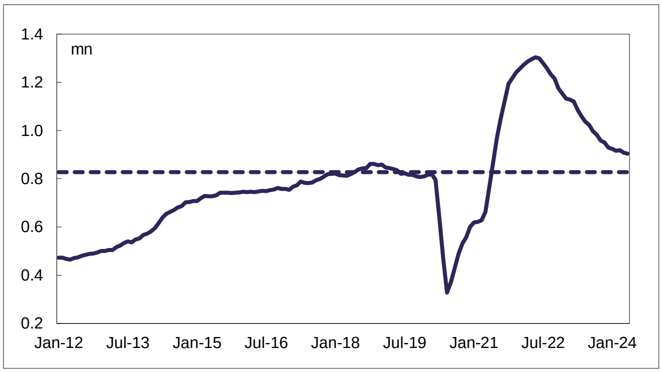
**Workforce jobs are quarterly data. Source: Macrobond and Daiwa Capital Markets Europe Ltd.*

UK: Claimant count rate



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Job vacancies*



**Dashed line represents 2019 average. Source: Macrobond and Daiwa Capital Markets Europe Ltd.*

challenges. And today's figures confirmed another increase in economic inactivity at the start of Q2, up a further 132k in the three months to April to the highest level for 12½ years due to an ongoing rise in long-term sickness – which has accounted for more than 80% of the cumulative 883k rise since the start of the pandemic in February 2020 – as well as an increase in the number of people staying at home to look after family.

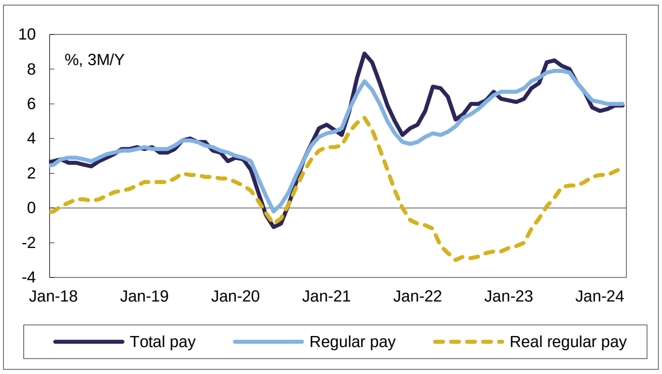
Declining employment and vacancies point to waning labour demand

Today's figures also suggested that labour demand continues to weaken. Certainly, having declined a sizeable 178k in Q1 – thanks to additional job cutting in the private sector – the LFS measure of employment fell a further 30k in April to 32.97mn, to leave it down some 360k compared with a year ago and some 37k below the pre-pandemic benchmark. The decline at the start of Q2 reflected a notable drop in the number of full-time workers (-145k) for the first time in eight months, while the number of part-timers rose slightly. Admittedly, there remains significant uncertainty regarding the true picture of the labour market due to the low survey response rate. For example, according to workforce jobs data – also published today – employment continued to rise in Q1, by 298k to 37.2mn, to leave it some 1.49mn above the pre-pandemic level. This is more aligned with HMRC's estimate of payrolls growth, which in Q1 rose a further 53k to 30.36mn, to be some 1.34mn above the February 2020 level. However, the number of payrolled employees has fallen in April and May, by a cumulative 39k, to leave annual growth in May (0.6%Y/Y) the softest for three years. The number of people claiming Job Seekers Allowance and Universal Credit also jumped in May (50.4k) by the most since February 2021. And so the claimant count rate rose for the first month in seven, by 0.2ppt to 4.3%, the highest for more than two years. While the number of job openings remains above the pre-pandemic level, it also maintained a steady downwards trend in May to 904k, some 400k below the peak three years ago, raising the likelihood of a drop in employment over coming months.

Wage growth a touch firmer than expected, but pay pressures to fade further over coming months

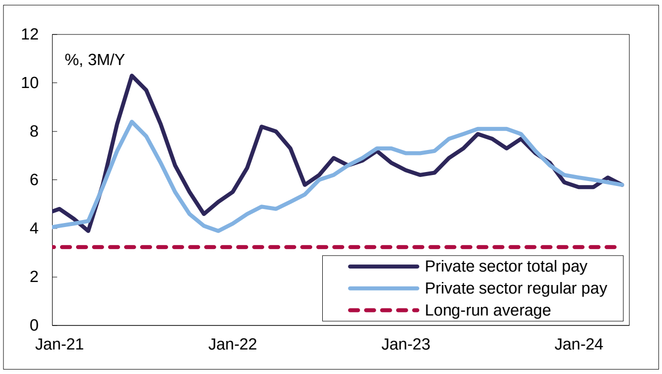
Despite the ongoing re-balancing of labour supply and demand, today's wage figures, at face value at least, suggested that pay pressures remained relatively strong at the start of Q2. In particular, total pay growth moved sideways at 5.9%3M/Y, having been upwardly revised by 0.2ppt in March, while regular wage growth was also unchanged at 6.0%3M/Y. And on a three-month annualised basis, total pay jumped to 8.2% and regular pay to 7.0% – the most in eight months – suggestive of accelerated pay momentum. But this in part reflected the near-10% increase in the National Living Wage that came into effect in April. Moreover, the latest developments in private sector regular pay – which is of particular interest to BoE policymakers in their assessments of domestically-driven inflationary pressures – were more encouraging, with annual growth easing for an eighth successive month, by 0.1ppt to 5.8%3M/Y, the lowest for 22 months. Admittedly, this remained well above the BoE's quarterly projection for Q2 (5.1%). Nevertheless, on a six-month basis, private regular pay momentum

UK: Nominal & real pay growth



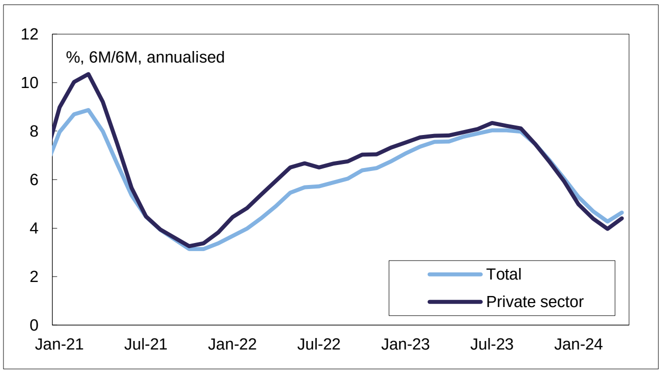
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Private sector pay growth



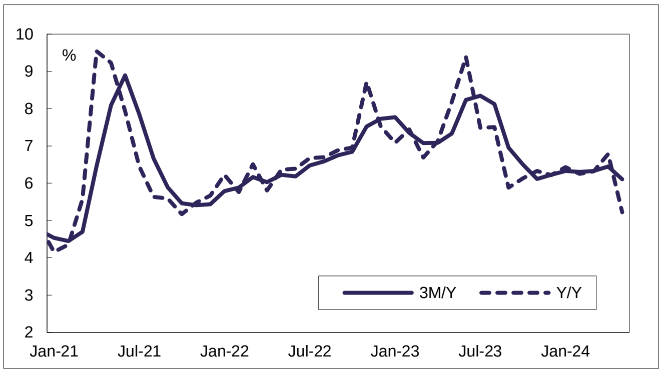
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Regular pay growth



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Median pay



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

(4.4%) was no stronger than in February and remained well below the average in 2023 (7.6%). More timely wage indicators also suggest that growth will moderate notably over coming months, reflecting not least base effects from strong pay a year ago. Certainly, median pay growth calculated from PAYE, dropped sharply in May, by 1.6ppts to 5.2%Y/Y, the lowest since February 2021. Furthermore, the boost to real wage growth to the highest rate in 2½ years might well satisfy employees who have been seeking compensation for past high inflation, leading to more modest pay demands over the coming year. Indeed, this would tally with the findings of the latest DMP survey, which suggest that firms' wage growth expectations for the twelve months ahead have eased to the lowest in more than two years.

The day ahead in the UK

Wednesday will bring monthly GDP figures for April, which are likely to report some payback for the jump of 0.4%M/M in March, which represented the strongest in nine months and meant that growth in Q1 reached a surprisingly strong 0.6%Q/Q, the best since Q421. We already know that retail sales were particularly weak in April, dropping 2.3%M/M, the most since December, in part due to bad weather. The early timing of Easter this year possibly contributed to a softer month for certain other services. And we think that manufacturing output likely reversed the growth of 0.3%M/M in March. So, while survey indicators were still upbeat that month – e.g. the composite PMI rose to a 12-month high of 54.1 – we think that GDP contracted in April by about 0.2%M/M. That, however, would leave the three-month rate at 0.6-0.7%3M/3M, pointing to the likelihood of another quarter of relatively firm expansion in Q2.

European calendar

Today's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
UK	Average earnings (excluding bonuses) 3M/Y%	Apr	**5.9 (6.0)**	5.7 (6.1)	5.7 (6.0)	5.9 (-)
	ILO unemployment rate 3M% (employment change 3M/3M 000s)	Apr	**4.4 (-139)**	4.3 (-95)	4.3 (-178)	-
	Payrolled employees change M/M 000s	May	**-3**	-	-85	-39
	Claimant count rate % (change 000s)	May	**4.3 (50.4)**	-	4.1 (8.9)	- (8.4)

Auctions

Country	Auction
- Nothing to report -	

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Yesterday's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Euro area	Sentix investor confidence	Jun	**0.3**	-1.7	-3.6	-
Italy	Industrial production M/M% (Y/Y%)	Apr	**-1.0 (-2.9)**	-0.2 (-2.1)	-0.5 (-3.5)	- (-3.2)

Auctions

Country	Auction
- Nothing to report -	

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data					
Country	BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Germany	07.00	Final HICP (CPI) Y/Y%	May	2.8 (2.4)	2.4 (2.2)
UK	07.00	Monthly GDP M/M% (3M/3M%)	Apr	*-0.2 (0.5)*	0.4 (0.2)
	07.00	Services activity M/M% (3M/3M%)	Apr	-0.1 (0.7)	0.5 (0.7)
	07.00	Industrial production M/M% (Y/Y%)	Apr	-0.1 (0.3)	0.2 (0.5)
	07.00	Construction activity M/M% (Y/Y%)	Apr	0.0 (-1.6)	-0.4 (-2.2)
	07.00	Trade (goods trade) balance €bn	Apr	-1.4 (-14.2)	-1.1 (-14.0)
Auctions and events					
Euro area	14.00	ECB Vice President de Guindos to discuss euro area growth and inflation outlook			
Germany	10.30	Auction: €4.0bn of 2.2% 2034 bonds			
UK	10.00	Auction: £900mn of 0.625% 2045 index-linked bonds			

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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