

Euro wrap-up

Overview

- Bunds followed USTs higher as final German inflation data for May provided no unpleasant surprises, confirming the flash estimates.
- Gilts rallied as data showed that UK GDP growth paused in April due not least to bad weather.
- Thursday will bring data for euro area industrial production and a UK housing market survey.

Chris Scicluna
+44 20 7597 8326

Emily Nicol
+44 20 7597 8331

Daily bond market movements

| Bond | Yield | Change |
|---------------|-------|--------|
| BKO 2.9 06/26 | 2.953 | -0.062 |
| OBL 2.1 04/29 | 2.561 | -0.085 |
| DBR 2.2 02/34 | 2.533 | -0.088 |
| UKT 0% 01/26 | 4.186 | -0.128 |
| UKT 0½ 01/29 | 4.003 | -0.138 |
| UKT 4% 01/34 | 4.124 | -0.142 |

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

Euro area

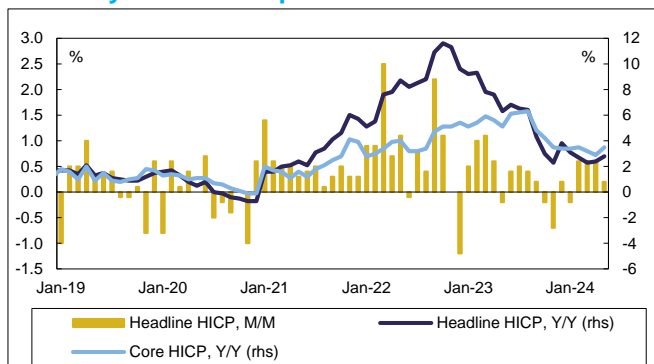
Final German inflation data for May provide no unpleasant surprises

The final estimates of German inflation in May brought no major unpleasant surprises, with the headline figures aligning with the initial numbers and the additional detail relatively un-perturbing. Notably, they confirmed that base effects and special factors were the main drivers of the increase rather than a significant upturn in underlying price pressures. Of course, the initial estimates had originally come in a touch above expectations, with the EU-harmonised HICP measure up 0.4ppt to a four-month high of 2.8%Y/Y, 0.1ppt above the Bloomberg survey median forecast. And the national CPI rate rose 0.2ppt to a three-month high of 2.4%Y/Y. As had been flagged by the flash data, the pickup in inflation was almost entirely driven by the services component (up 0.8ppt to 4.7%Y/Y on the national measure when excluding rent, but up 1.1ppt to 4.7%Y/Y on the EU-harmonised measure). Today's figures confirmed that principally reflected a base effect related to the introduction of the €69 Deutschland public transport ticket a year ago. Indeed, while network transport ticket prices, including those for bus and rail, had been down 24.0%Y/Y on the national measure in April, they were up 3.5%Y/Y in May. Another typically erratic item – package tours, which often explains the difference between the national and EU-harmonised rates – was also significantly stronger in May, up 3.1ppt on the HICP measure to a three-month high of 5.6%Y/Y. But while still highly elevated, inflation of insurance (12.5%Y/Y) and hospitality (6.9%Y/Y) moderated slightly. And telecoms charges fell 0.4%Y/Y, down 1.2ppt on the month.

Fall in core goods inflation takes edge off jump in services

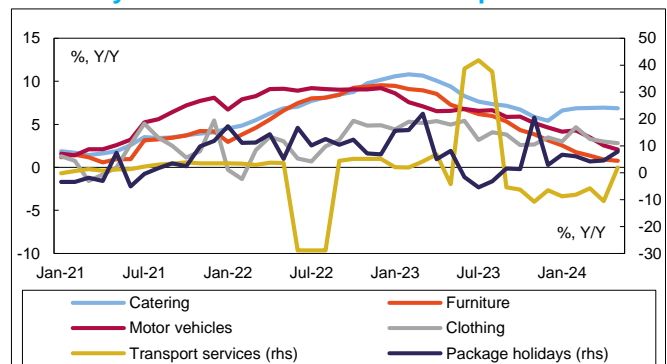
In contrast to the jump in services, a range of core goods components, including cars, clothing, household appliances and furniture, declined in May in line with the global trend. But while German core CPI inflation on the national measure was unchanged at 3.0%Y/Y, matching the lowest in more than two years, the EU-harmonised core rate jumped 0.6ppt to 3.5%Y/Y. The difference between the two reflects in particular the contrast in the treatment of package tours and rents. Meanwhile, in non-core components, despite the withdrawal of government support and further jump in petrol prices, energy inflation remained firmly in negative territory (up 0.1ppt to -1.1%Y/Y). And food inflation remained very weak too (up 0.1ppt to 0.6%Y/Y). Looking ahead, base effects mean that energy inflation will soon return to positive territory. But producer and wholesale price data suggest that the food and core goods components should remain subdued. And while the services component will likely remain volatile and relatively elevated due to strong wage growth, we expect German core inflation on both the national and EU-harmonised measures to trend gradually lower over coming quarters, keeping alive the prospect of further rate cuts.

Germany: Consumer price inflation*



*EU-harmonised measure. Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Germany: Selected CPI inflation components**



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

The day ahead in the euro area

Thursday will bring aggregate euro area industrial production figures for April. While national figures saw output rise modestly in Germany (0.3%M/M), France (0.5%M/M) and notably in Greece (7.0%M/M), production also fell for the third month out of four in Italy (-1.0%M/M) and sharply in Ireland (-3.4%M/M). So, on balance, we think that euro area output likely fell very modestly for the first month in three, with our forecast for a drop 0.1%M/M. Given the recent monthly profile, this would still leave output a little more than ½% above the Q1 level.

UK

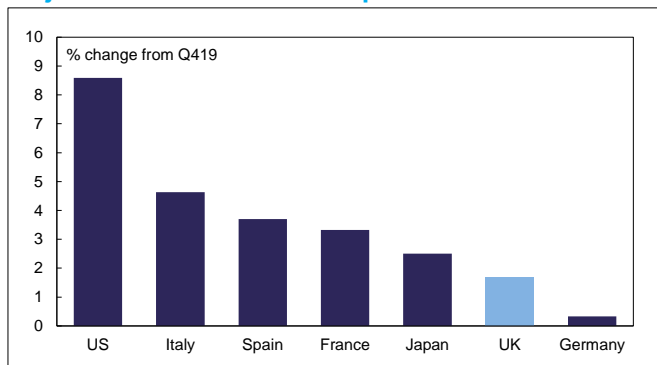
GDP moved sideways at the start of Q2 and surveys point to moderation in momentum in May

Today's monthly GDP data suggested that economic growth paused at the start of Q2 as the adverse weather conditions took their toll. Admittedly, today's release marginally beat expectations of a modest contraction, with output moving sideways at March's relatively elevated level. Indeed, having risen in each of the first three months of the year, this left output up 0.7%3M/3M in April – the firmest such growth since May 2022 – and 2.6% above the pre-pandemic benchmark in February 2020. Of course, the UK's recovery continues to lag behind its peers, with the level of GDP in Q1 compared with Q419 some 8½% higher in the US and 3½% higher in the euro area. And UK economic output is still some 7½% below the pre-Brexit trend, illustrating the lacklustre performance of the past eight years. While retail surveys suggest that sales rebounded in May, and the manufacturing and construction PMIs implied the firmest growth in two years, the services PMI fell to a six-month low (52.9), signalling a moderation in economic momentum in the middle of Q2. Nevertheless, given today's slight upside surprise, we have nudged slightly higher our expectation for GDP growth in Q2 to 0.4%Q/Q, a moderation from the pace in Q1 (0.6%Q/Q), but well above the BoE's projection of 0.1%Q/Q on the assumption of an unchanged Bank Rate published last month.

Business services offset manufacturing and construction weakness in April

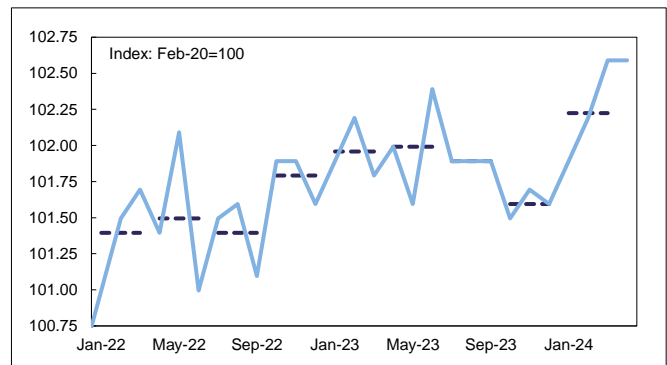
Within the detail in April, despite a drag from retail (-2.3%M/M) and hospitality (-1.0%M/M), services activity rose for a fourth consecutive month, by 0.2%M/M, supported by solid growth in ICT and other business services subsectors. This left services activity up 0.9%3M/3M, the strongest such growth since January 2022, and the main driver of GDP growth on a three-month basis. Indeed, industrial production started the second quarter on the back foot, with the 0.9%M/M decline in April the steepest for six months. This reflected weakness in manufacturing, where output fell a larger 1.4%M/M – the most since

Major economies: GDP comparison in Q124



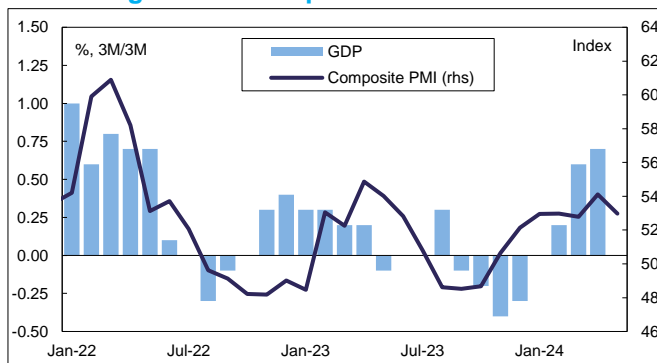
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: GDP level*



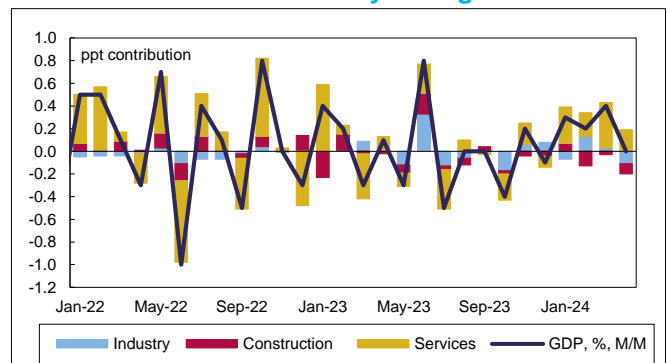
*Dashed dark blue line represents quarterly average. Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: GDP growth & composite PMI



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Contributions to monthly GDP growth



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

January 2021 – reflecting a notable drop in production of pharmaceuticals (-6.1%M/M), food (-2.3%M/M) and electrical equipment (-6.8%M/M). Indeed, only 3 of the 13 subsectors contributed positively to monthly manufacturing output growth in April, of which other machinery and equipment (1.2%M/M) fared best. The construction sector also remained a weak link in April, with anecdotal evidence suggesting that unseasonably wet weather and storm Kathleen disrupted activity, which fell 1.4%M/M in April. This marked the sixth monthly drop out of the past seven to be down 2.2%3M/3M – the most since July 2020 – and 3.3% lower compared with a year earlier. And the weakness was broad based across the sector, with repair and maintenance dropping for a third consecutive month following the steady uptrend of recent years, while new building work fell for a ninth month out of ten (-1.9%M/M). Consistent with the PMI surveys, the decline was most marked in new private and public housing work (-4.4%M/M and -5.6%M/M respectively), with the former down more than 12%Y/Y to its lowest level since the first pandemic lockdown.

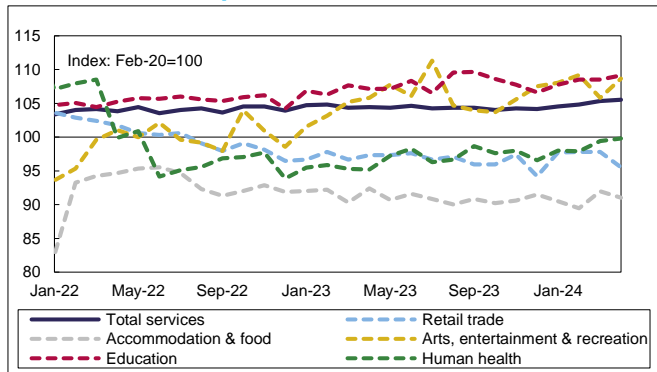
Net trade provides a drag on growth at start of Q2 as imports surge and exports weaken

Having provided a notable boost to GDP growth in Q1, net trade appears to have weakened markedly at the start of Q2. Certainly, today’s data suggested a marked widening in the trade deficit in April, by £5.7bn to £6.75bn, a near-two-year high. While export values fell (-0.7%M/M) to the lowest level in six months, the deterioration principally reflected a 7.2%M/M jump in the value of imports – the most since January 2022 – amid a strong increase in machinery and equipment relating to large imports of aircraft from France, as well as mechanical machinery from Germany. Imports of fuel were also higher related in part to the increase in the oil price that month. But when excluding price effects, import volumes were still up a striking 6.7%M/M (+5.2%M/M when excluding the often-volatile precious metals). Moreover, export volumes were down 2.1%M/M (-0.9%M/M ex. precious metals) as goods exports slumped 5.3%M/M (-2.8%M/M ex precious metals). So, while we might well see some bounce back in May for the likely one-off influences in April, today’s figures strongly suggest that net trade will be a non-negligible drag on GDP growth in Q2.

The day ahead in the UK

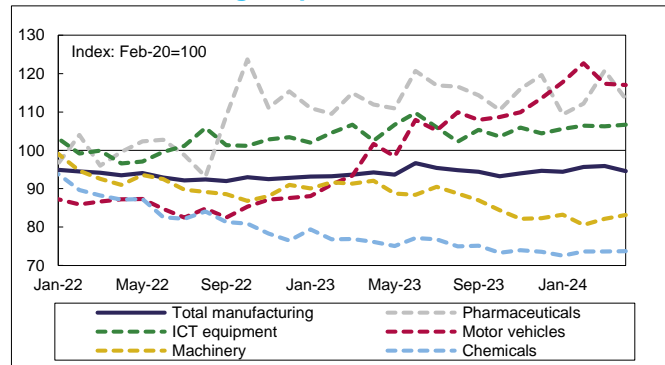
A relatively quiet day for UK data releases tomorrow will bring the RICS Residential Market Survey for May. Despite a further modest improvement in consumer confidence and rising disposable incomes, respondent surveyors on balance likely reported another modest decline in house prices in May (-5%), unchanged from readings in March and April but nevertheless well above last year’s trough (-66%).

UK: Services output



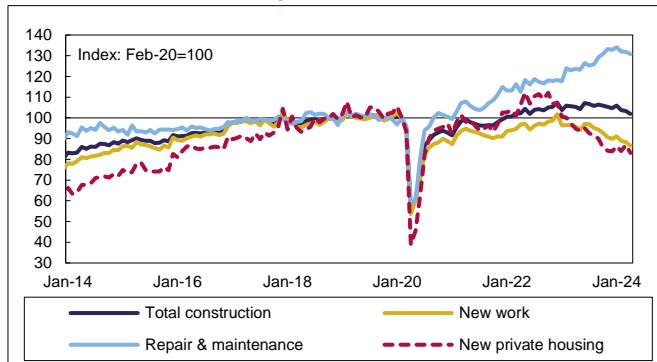
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Manufacturing output



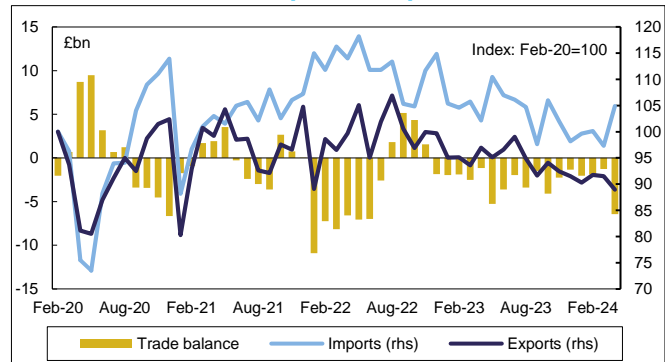
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Construction output



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Trade balance, export & import volumes





Source: Macrobond and Daiwa Capital Markets Europe Ltd.



European calendar

Today's results

Economic data

| Country | Release | Period | Actual | Market consensus/ <i>Daiwa forecast</i> | Previous | Revised |
|---|-----------------------------------|--------|---------------------|--|--------------|---------|
| Germany  | Final HICP (CPI) Y/Y% | May | 2.8 (2.4) | 2.8 (2.4) | 2.4 (2.2) | - |
| UK  | Monthly GDP M/M% (3M/3M%) | Apr | 0.0 (0.7) | <u>-0.2 (0.5)</u> | 0.4 (0.2) | - |
| | Services activity M/M% (3M/3M%) | Apr | 0.2 (0.9) | -0.1 (0.7) | 0.5 (0.7) | - |
| | Industrial production M/M% (Y/Y%) | Apr | -0.9 (-0.4) | -0.1 (0.3) | 0.2 (0.5) | - |
| | Construction activity M/M% (Y/Y%) | Apr | -1.4 (-3.3) | 0.0 (-1.6) | -0.4 (-2.2) | - |
| | Trade (goods trade) balance £bn | Apr | -6.8 (-19.6) | -6.8 (-19.6) | -1.1 (-14.0) | - |




Auctions

| Country | Auction |
|---|---|
| Germany  | sold €3.33bn of 2.2% 2034 bonds at an average yield of 2.6% |
| UK  | sold £900mn of 0.625% 2045 index-linked bonds at an average yield of 1.304% |


Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

| Country | BST | Release | Period | Market consensus/ <i>Daiwa forecast</i> | Previous |
|---|-------|-----------------------------------|--------|--|------------|
| Euro area  | 10.00 | Industrial production M/M% (Y/Y%) | Apr | <u>-0.2 (-2.2)</u> | 0.6 (-1.0) |
| Spain  | 08.00 | Final HICP (CPI) Y/Y% | May | 3.8 (3.6) | 3.4 (3.3) |
| UK  | 00.01 | RICS house price balance % | May | -5 | -5 |

Auctions and events

| | | |
|---|-------|-----------------------------|
| Italy  | 10.00 | €4.0bn of 3.45% 2027 bonds |
| | 10.00 | €2.5bn of 3.45% 2031 bonds |
| | 10.00 | €1.25bn of 4.15% 2039 bonds |
| | 10.00 | €1.25bn of 3.85% 2049 bonds |

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Access our research blog at:

<https://www.uk.daiwacm.com/ficc-research/recent-blogs>

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