

Euro wrap-up

Overview

- Bunds made modest gains as final euro area inflation data confirmed that the uptick in May was due principally to one-off effects in services, while the share of the inflation basket with above-target inflation fell below 50%.
- Gilts followed USTs higher on a day with no top-tier UK economic data.
- Wednesday will bring UK inflation figures for May, as well as euro area construction output data for April.

Emily Nicol

+44 20 7597 8331

Daily bond market movements

Bond	Yield	Change
BKO 2.9 06/26	2.799	-0.007
OBL 2.1 04/29	2.408	-0.012
DBR 2.2 02/34	2.392	-0.019
UKT 0% 01/26	4.122	-0.067
UKT 0½ 01/29	3.911	-0.077
UKT 4% 01/34	4.046	-0.067

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

Source: Bloomberg

Euro area

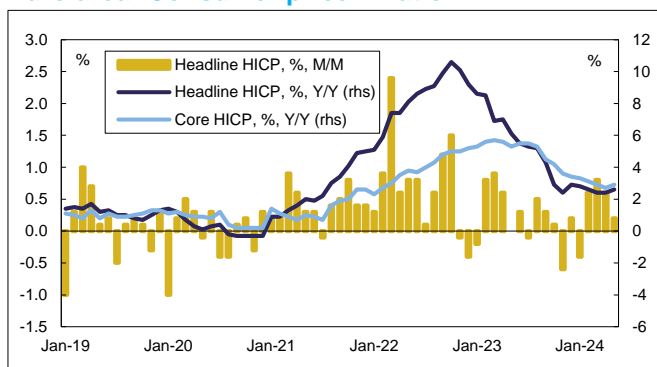
Increase in inflation in May due principally to one-off effects in services

There were no major surprises in today's final euro area inflation figures for May, which aligned with the flash estimates published at the end of last month. Of course, these figures had initially exceeded expectations, with the headline and core HICP rates up 0.2ppt a piece to 2.6%Y/Y and 2.9%Y/Y respectively. As was clear already, the main cause of higher inflation in May was the services component, which rose 0.4ppt to a seven-month high of 4.1%Y/Y. And according to the ECB's seasonally adjusted figures, services momentum accelerated, up to 5.4%3M/3M annualised, the strongest in a year. When the flash figures had been published, that had raised concerns among the more hawkish Governing Council members about persistence in that component. But the detail in today's figures confirmed that the pickup last month principally reflected one-off or temporary factors, including a significant base effect associated with the introduction a year ago of the German discounted public transport ticket. Indeed, inflation of combined passenger transport was up a whopping 19.6ppts to 2.8%Y/Y to account for roughly half of the increase in the services component. There was also additional upwards pressure from typically volatile services items such as package holidays and accommodation services – up to a six-month high of 8.7%Y/Y and 6.1%Y/Y respectively – likely associated with the timing of Easter. In contrast, restaurant services inflation moderated slightly to the softest in more than two years, while insurance inflation – another recent source of pressure – also edged slightly lower from April's peak.

Energy inflation ticks higher on base effects, but other goods inflation continues to fade

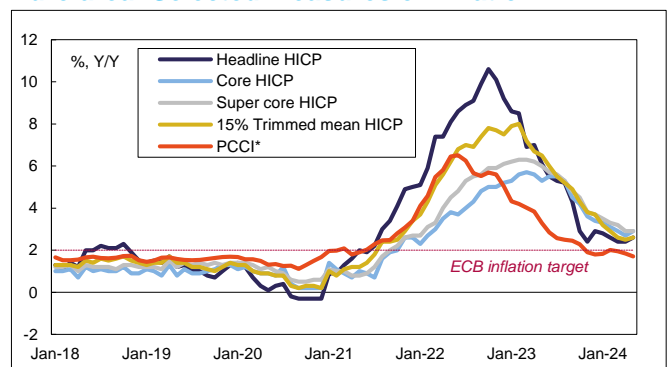
The other major component to contribute to the rise in inflation in May was energy. Despite the further withdrawal of government support, energy prices overall fell 1.2%M/M last month due to the drop in prices of auto fuel and heating oil. However, given the sharper fall a year ago, energy inflation rose 0.9ppt to a 13-month high of 0.3%Y/Y. More encouragingly, 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 as momentum in that category (0.7%3M/3M annualised) continued to fade. And a minimal rise in core goods prices pushed the respective annual rate down a further 0.2ppt to 0.7%Y/Y, the lowest since July 2021. Today's detail confirmed an ongoing downtrend in inflation of a range of goods including furnishings, second-hand cars and clothing, as well as deflation in household appliances. And although surveys and producer price data suggest that disinflation pressures in the factory sector are fading, today's figures signalled a continued absence of momentum in consumer core goods inflation.

Euro area: Consumer price inflation



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Selected measures of inflation



*Persistent and Common Component of inflation. Source: Macrobond, ECB and Daiwa Capital Markets Europe Ltd.

Share of inflation basket with above-target inflation falls below 50%

Today's figures also confirmed a further moderation in the share of items in the HICP basket with above-target inflation in May, which fell below 50% for the first time since October 2021, down from a peak of more than 90% in January 2023 and roughly 20ppts lower than at the end of last year. Other measures of underlying inflation also suggested a more modest increase than the core HICP rate implied. For example, the 15% trimmed mean rate rose just 0.1ppt to 2.6%Y/Y, still the second-lowest since October 2021. Moreover, the persistent and common component of inflation (PCCI) – which ECB staff believe can provide one of the more reliable guides to future inflation – fell 0.2ppt to 1.7%3M/Y, the lowest since December 2020, with the core PCCI rate similarly down to 1.7%Y/Y, a near-three-year low.

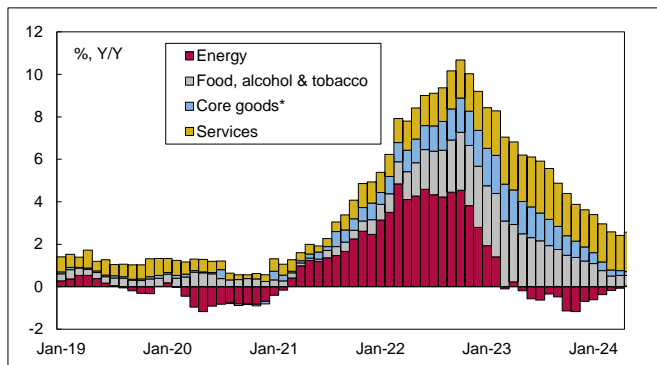
Near-term inflation profile to be choppy due to further base effects and one-offs

Despite the improvement in certain measures of underlying price pressures, the near-term inflation profile remains uncertain and is likely to be choppy. Food inflation probably has a little further to decline, while core goods inflation will remain very subdued into autumn. However, despite a further decline in auto fuel prices so far this month, base effects will contribute to a very volatile profile for energy inflation. And while survey indicators suggest an easing in selling price expectations as firms are seemingly less inclined to try to pass on increased costs onto customers, services inflation will likely remain close to current elevated levels over the remainder of the year. As such, while we expect headline inflation to take a step down close to the 2% target over the summer, core inflation will ease only slightly further and not fall back below 2½% until next spring. Nevertheless, today's reassuring detail should keep the door open to further easing in September. And one cut of 25bps each quarter well into 2025 remains our baseline expectation.

Investors remain more upbeat about the German economic outlook

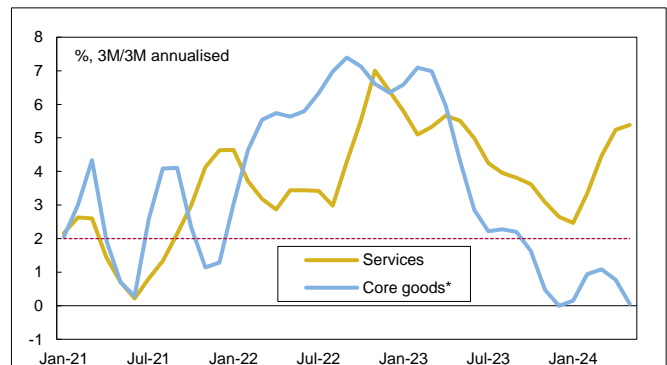
Today's ZEW survey suggested that investors still judge that inflationary pressures are dissipating in Germany. But the net share expecting inflation to fall over the coming six months (-36.8) was nevertheless the smallest in 20 months. The seemingly more uncertain price outlook might have contributed to a slight worsening in investor perceptions of current economic conditions this month, with the respective net balance slipping back for the first month in four to -73.8, well below the long-run average (-11.3) but nevertheless still some 5ppts above the average in the previous nine months. This tallies with other survey measures suggesting another quarter of solid GDP growth in Q2. And despite the rise in political uncertainty in the region following French President Macron's decision to call a snap parliamentary election, investors were still more upbeat about the German economic outlook over the coming six months amid expectations of further rate cuts ahead. In particular, the balance of investors expecting economic conditions to improve increased for an eleventh consecutive month

Euro area: Contributions to HICP inflation



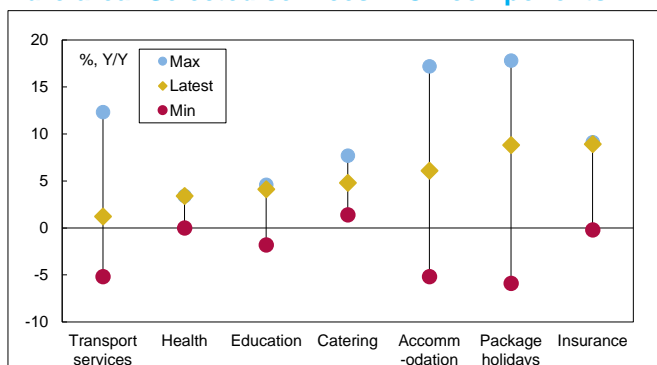
*Non-energy industrial goods. Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Core inflation momentum



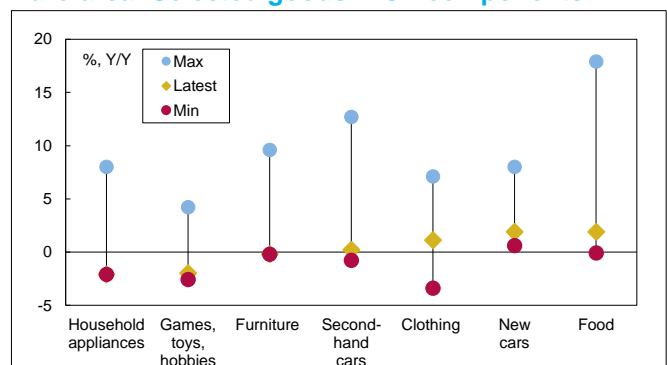
*Non-energy industrial goods. Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Selected services HICP components



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Selected goods HICP components



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

to 47.5, the highest since February 2022, some 26ppts above the long-run average, leaving the quarterly average in Q2 some 24ppts above the Q1 level.

The day ahead in the euro area

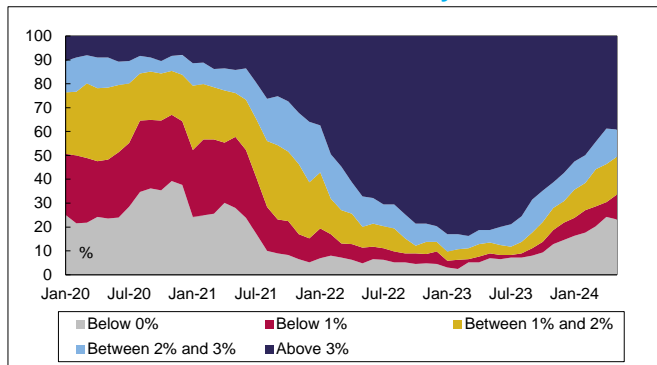
Wednesday will bring euro area construction output figures for April. Coming on the back of four consecutive increases, we expect aggregate activity to have started the second quarter on the back foot, reflecting not least sharp declines in Germany (-2.1%M/M) and France (-1.0%M/M) following the weather-assisted boost earlier in the year.

UK

The day ahead in the UK

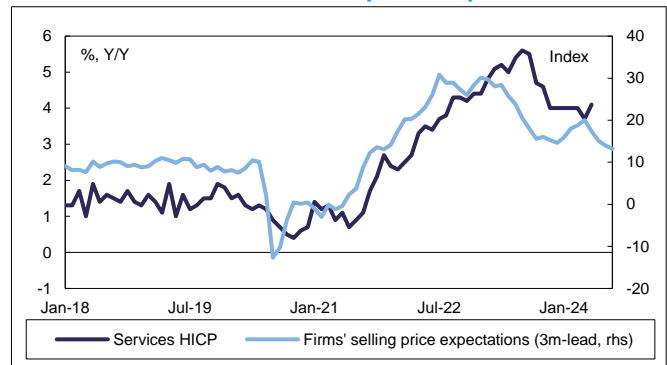
After a quiet start to the week for UK economic data and ahead of the BoE's monetary policy announcement on Thursday, focus tomorrow will be firmly on the May inflation figures, which we expect to show that headline and core inflation as well as the services component moderated last month. Indeed, in line with the Bloomberg survey consensus, we forecast the CPI rate to drop 0.3ppts to 2.0%Y/Y, matching the BoE's inflation target for the first time in almost three years. We also expect core inflation to drop 0.5ppts to 3.4%Y/Y, which would mark the softest rate since October 2021, thanks principally to lower non-energy industrial goods inflation. But services inflation will almost certainly again exceed the BoE's projection (5.3%Y/Y).

Euro area: Share of HICP basket by inflation rate



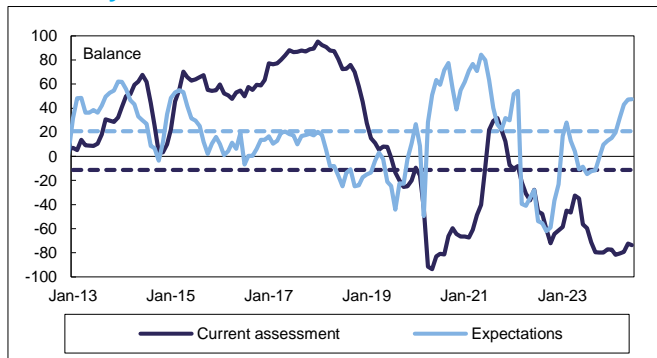
Source: Eurostat and Daiwa Capital Markets Europe Ltd.

Euro area: Services HICP & price expectations



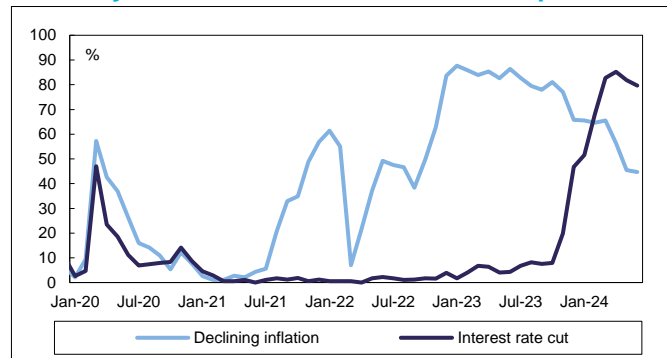
Source: EC, Macrobond and Daiwa Capital Markets Europe Ltd.

Germany: ZEW investor sentiment indices*



*Dashed lines represent long-run average. Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Germany: ZEW inflation & interest rate expectations*





*Coming six months. 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
Euro area 	Final HICP (core HICP) Y/Y%	May	2.6 (2.9)	2.6 (2.9)	2.4 (2.7)	-
Germany 	ZEW current situation (expectations) balance	Jun	-73.8 (47.5)	-	-72.3 (47.1)	-



Auctions

Country	Auction
Germany 	sold €3.36bn of 2039 bonds at an average yield of 2.45%
UK 	sold £4.0b of 2029 bonds at an average yield of 4.083%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Yesterday's results

Economic data

Country	Release	Period	Actual	Market consensus/ <i>Daiwa forecast</i>	Previous	Revised
Euro area 	Labour costs – 2 nd estimate Y/Y%	Q1	5.1	4.9	3.4	-
Italy 	Final HICP (CPI) YY%	May	0.8 (0.8)	0.8 (0.8)	0.9 (0.8)	-



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/ <i>Daiwa forecast</i>	Previous
Euro area 	10.00	Construction output M/M% (Y/Y%)	Apr	-	0.1 (0.1)
UK 	07.00	CPI (core CPI) Y/Y%	May	<u>2.0 (3.4)</u>	2.3 (3.9)
	07.00	PPI – input (output) prices Y/Y%	May	-0.2 (1.7)	-1.6 (1.1)
	07.00	House price index Y/Y%	Apr	-	1.8

Auctions and events

Germany 	10.30	Auction: €2.0bn of 2.5% 2054 bonds
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Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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