Daiwa Capital Markets

Euro wrap-up

Overview

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- Bunds made modest losses as the Commission launched formal Excessive Deficit Procedures against France and Italy.
- While headline UK inflation returned to target, Gilts made losses as services inflation exceeded the BoE's most recent projection.
- On Thursday the BoE will leave Bank Rate unchanged for an eighth successive meeting, while the Commission's preliminary consumer confidence indicator for June is also due.

Daily bond market movements

Bond	Yield	Change
BKO 2.9 06/26	2.802	+0.006
OBL 2.1 04/29	2.417	+0.007
DBR 2.2 02/34	2.402	+0.009
UKT 0⅛ 01/26	4.161	+0.038
UKT 0½ 01/29	3.926	+0.015
UKT 4⅝ 01/34	4.066	+0.019

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

Euro area

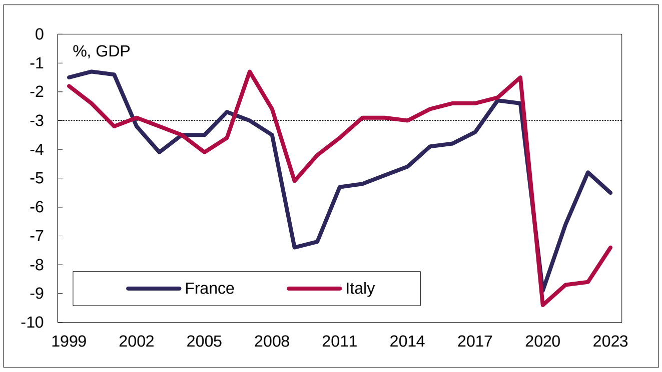
No surprise as Commission launches new procedures against French & Italian excessive deficits

Against the backdrop of heightened investor concerns about the forthcoming French parliamentary elections, which last week triggered a notable widening of spreads of OATs over Bunds back to their 2017 highs and underperformance of BTPs, the European Commission today launched formal Excessive Deficit Procedures (EDPs) against seven EU member states including France and Italy. The decision was inevitable following the significant overshooting of fiscal targets in both countries last year. Indeed, the general government budget deficits at 5.5% of GDP in France and 7.4% in Italy, and debt stocks well above 100% of GDP in both countries, were well above initial plans and a long way above the respective 3% and 60% Stability and Growth Pact (SGP) limits with no mitigating circumstances. The member states' governments will need to present by 20 September medium-term fiscal consolidation plans – for assessment by the Commission – setting out ceilings for net public spending growth to ensure a return to SGP compliance.

Politics extremely unlikely to be consistent with SGP requirements in either country

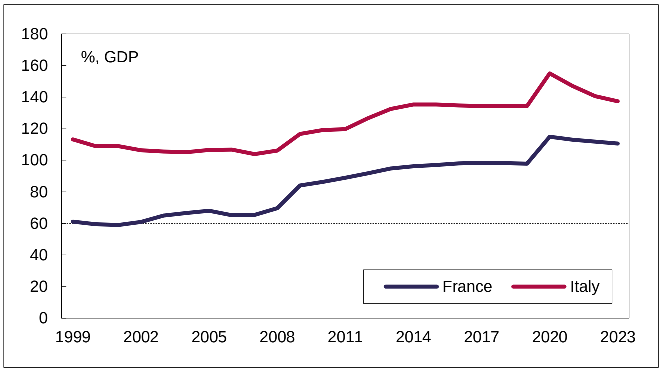
Given the current woeful ratings of President Macron's Renaissance group, the French government that emerges from the forthcoming elections would seem extremely unlikely to be willing to implement policy consistent with increased fiscal sustainability, let alone SGP-compliance. Certainly, neither of the two main groupings likely to win the lion's share of seats in the next French lower house have credible policies consistent with fiscal consolidation. Among other things, the far-right RN has pledged tax cuts – including reduced VAT on energy and fuel – as well as a reversal of Macron's increase in the retirement age. The left-wing bloc is committed to an even larger blowout in public spending, including significant increases in public sector pay and the reversal of Macron's pension reforms, which one of its own candidates has priced (probably conservatively) at upwards of €100bn. Likewise, French policy paralysis in the event of a hung parliament – which is still the most likely outcome of the election – would seem likely to imply a failure to comply with the SGP. Meanwhile, although its parliamentary majority would provide greater scope to deliver the required consolidation over coming years, the current commitments of Italy's ruling coalition are not compatible with the SGP. So, heading into the autumn, PM Meloni's fiscal policy decisions will have consequences for the stability of her government. Thus, despite the Commission's attempt to enforce EU law via its new EDPs, political noise and concerns about fiscal sustainability in the euro area's second- and third-largest member states will remain a theme this year and probably for the foreseeable future too.

France & Italy: General government balance*



**Dashed line represents 3% SGP limit. Source: Macrobond and Daiwa Capital Markets Europe Ltd.*

France & Italy: General government debt*



**Dashed line represents 60% SGP limit. Source: Macrobond and Daiwa Capital Markets Europe Ltd.*

Construction activity starts Q2 on the backfoot reflecting renewed drop in Germany and France

More prosaically, consistent with sentiment surveys and tallying with developments in the manufacturing sector, today's euro area data suggested that the construction sector also started the second quarter on the back foot. In particular, output declined for a second successive month in April, albeit by a modest by 0.2%M/M, to leave it down 1.1%Y/Y and ½% below the Q1 average. The weakness was led by the first monthly drop in four in civil engineering activity (-1.1%M/M). In contrast, building work was merely unchanged having fallen in two out of the previous three months, to be some 0.2% below the Q1 average. Activity across the member states was mixed, with weakness in Germany (-2.1%M/M) following a weather-assisted surge in Q1, and France (-1.0%M/M), offsetting ongoing expansion in Spain (1.0%M/M) and Portugal (4.1%M/M). Survey indicators suggest that shrinking order books will continue to constrain output over coming months too. Indeed, the Commission survey signalled that almost one third of firms judge weak demand to be a limiting factor on activity, while the share of firms citing weather as a constraint rose in May to a five-month high. And the construction PMIs suggest that activity in Germany and France remained in reverse last month with momentum in the sector in Italy softening too.

The day ahead in the euro area

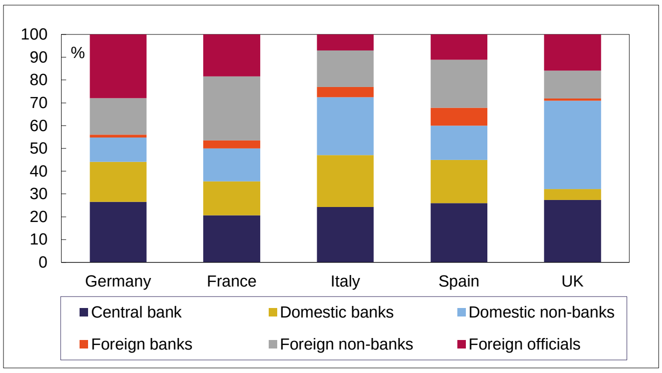
Thursday will bring the Commission's preliminary consumer confidence survey results for June. In May, the headline indicator rose to -14.3, suggesting that households were the most upbeat since the Russian invasion of Ukraine amid improved expectations for household incomes and the general economic outlook. Against this backdrop, household purchase intentions over the coming twelve months were similarly the highest since February 2022. This notwithstanding, euro area car registration figures for May – also due tomorrow – are likely to have remained subdued. Among the larger member states to publish data, there were further declines on a year-on-year basis last month in Germany (-4.3%Y/Y), France (-2.9%Y/Y), Italy (-6.6%Y/Y) and Belgium (-5.9%Y/Y), contrasting a modest increase in Spain (3.4%Y/Y)

UK

Inflation back on target but detail not sufficiently soft to prompt a rate cut tomorrow

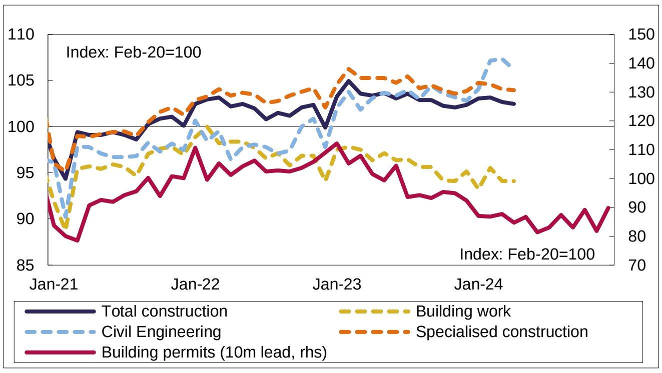
Ahead of tomorrow's BoE monetary policy announcement, today's data showed that UK inflation returned to the BoE's 2.0%Y/Y target in May for the first time in more than three years. Core inflation declined too, with the components for services and non-energy industrial goods both lower. And the share of items in the CPI basket with above-target inflation fell below 50% for the first time since July 2021. Nevertheless, to some extent the details of the figures were somewhat

Euro area: Holders of general government debt*



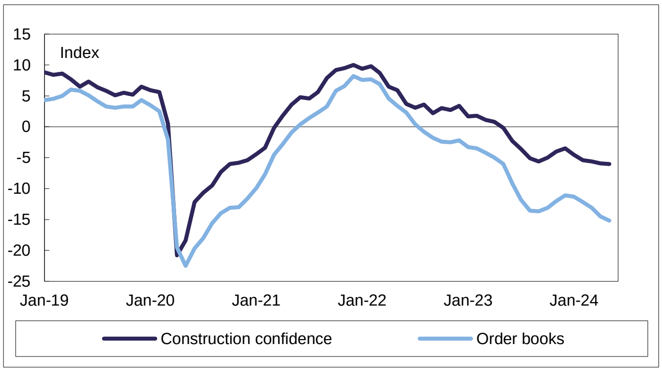
*Q423. Source: IMF, Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Construction activity & building permits



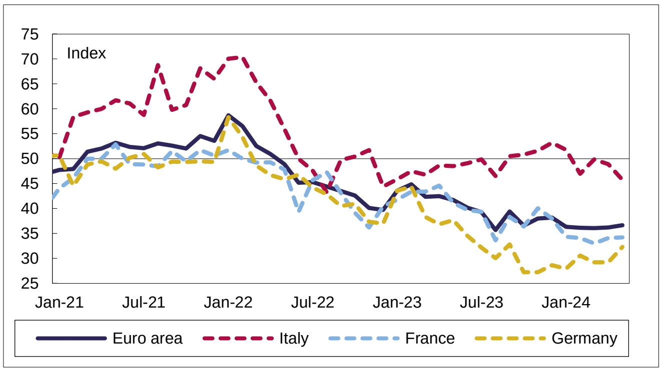
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Construction sentiment indices



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

Euro area: Construction PMIs by member state



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

disappointing. With the general election a fortnight away, the case for easing policy would need to be particularly compelling for the MPC to vote for a rate cut at tomorrow's meeting. And despite the return of inflation to target, the detail of today's data did not fulfil the necessary criteria. But while Bank Rate will therefore again be left unchanged tomorrow, we do think that the risks of inflation persistence have receded significantly. And assuming that there are no major surprises in the next round of inflation and labour market data, we still expect a first cut in Bank Rate to come in August.

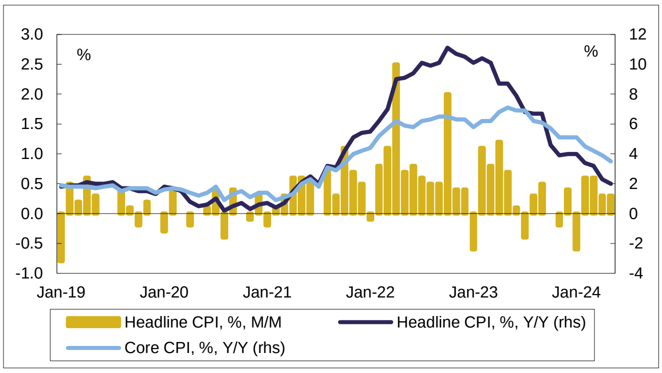
Core goods inflation in negative territory on global trends & bad weather

The drop of 0.3ppt in headline CPI inflation in May to 2.0%Y/Y was in line with our own forecast and the Bloomberg survey median. But it was 0.1ppt above the BoE's projection. The fall came despite a pickup of almost 1ppt in energy inflation (to -15.9%Y/Y) as an unfavourable base effect more than offset the impact of lower petrol prices. However, the other major inflation components declined. With prices down on the month for the first time in almost three years to catch up with recent developments in other major economies, inflation of food, alcohol and tobacco fell almost 1ppt to the lowest since November 2021 (3.3%Y/Y). In addition, broadly in line with our expectation and the market consensus, the core CPI rate fell 0.4ppt to 3.5%Y/Y, the lowest since October 2021, with the downward pressures relatively broad-based. Indeed, eye-catchingly, but largely consistent with global trends, core goods inflation fell into negative territory for the first time since 2016. Prices of a wide range of such items, from furniture to electrical appliances and second-hand cars, were well below levels a year earlier. Some of the weakness, however, particularly in items such as garden furniture and clothing, likely also reflected the inclement weather as consumers felt no need to buy summer-related goods.

Services inflation falls less than BoE expected

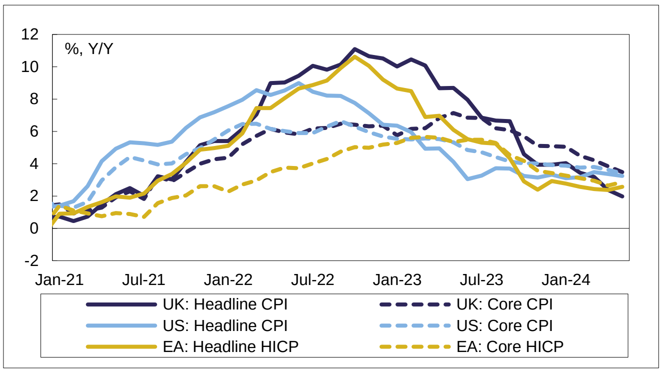
Most notably, services inflation fell for a fourth consecutive month, by 0.2ppt in May to 5.7%Y/Y, the lowest since July 2022. The continued downtrend in this component, which currently has a significant weight in the MPC's policy reaction function, was arguably encouraging. However, as well as being still significantly above the equivalent rates in the US and euro area, UK services inflation was crucially a chunky 0.4ppt above the BoE's projection. Within the detail, some of the drop was explained by Easter effects, with airfares recording the steepest annual drop since October 2020, package holiday inflation at a near-two-year low and the restaurant component the softest since March 2022. Like in the euro area and US, insurance inflation – a recent source of pressure – also moderated slightly to its lowest level in two years, albeit remaining in double-digit territory. But inflation of hotel services remained sticky in May. As such, we estimate that the drop in the BoE's so-called core services measured (which excludes airfares, package holidays, rents and education) was minimal, down 0.1ppt to 5.1%Y/Y, nevertheless still the softest in more than two years.

UK: Consumer price inflation



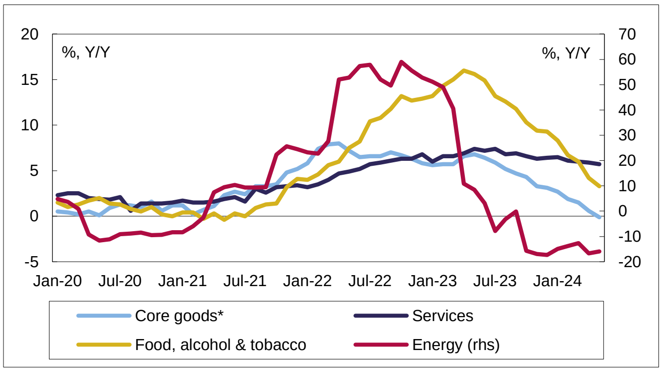
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Headline & core inflation in UK, euro area & US



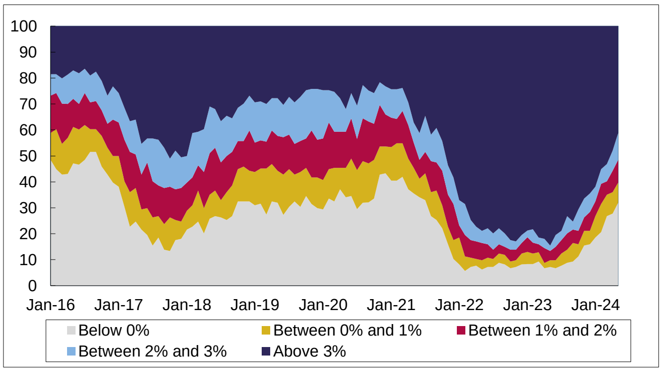
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Key inflation components



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

UK: Share of CPI basket by inflation rate



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

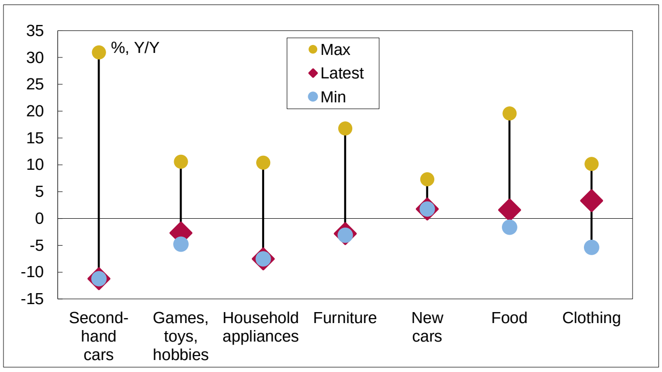
Near-term inflation profile to remain choppy but should allow a first rate cut in August

The near-term inflation profile remains uncertain and is likely to be choppy. Despite the decline in petrol prices so far this month and a further cut in Ofgem's household price cap to come in July, the pace of decline in energy inflation will moderate significantly over the coming couple of months due to substantial base effects. In contrast, we expect food inflation to maintain a downtrend. And while manufacturing surveys and today's producer price figures signal a recent modest pickup in factory sector costs, core goods inflation will likely remain very subdued. Most importantly, in part due to firm recent pay growth, services inflation will likely remain sticky close to current rates over the summer. But there are signs of a softening in the labour market, with firms' wage growth expectations down to a two-year low. And survey indicators such as the PMIs suggest that cost pressures in services are growing little stronger than the long-run average, while the scope to pass on such costs to customers has fallen to a three-year low. So, we continue to expect services inflation to take a more sizable step down to below 5.0%Y/Y from the end of the year. That should allow core inflation to fall below 3%Y/Y at year-end, with an ongoing moderation of price pressures to take it below 2% from Q225. Headline inflation should also be broadly in line with the 2% target from next spring. As such, in the absence of significant shocks, we maintain our view that the MPC will vote to cut Bank Rate by 25bps for the first time this cycle in August, with further cuts of 25bps each quarter to follow through to end-2025.

The day ahead in the UK

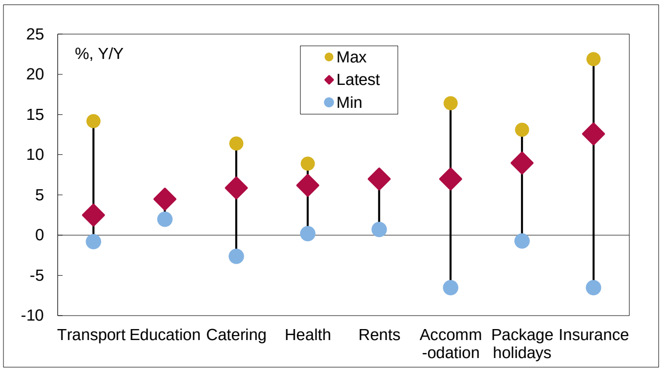
The main focus in the UK tomorrow will be the BoE's monetary policy announcement. Given the current general election campaign period, the persistence in services inflation in today's figures and stronger than expected economic output in the first half of the year, the MPC seems bound to leave Bank Rate unchanged at 5.25% for the eighth successive monetary policy meeting. As in May, two members (Deputy Governor Ramsden and uber-dove Dhingra) will likely vote for a cut while the other seven members are likely to support the status quo. Like last month, the MPC's statement will likely reiterate that future rate decisions will be data-dependent, with a cut considered likely to come in future if and when the evidence suggests that the risks of inflation persistence have further receded.

UK: Selected goods inflation components



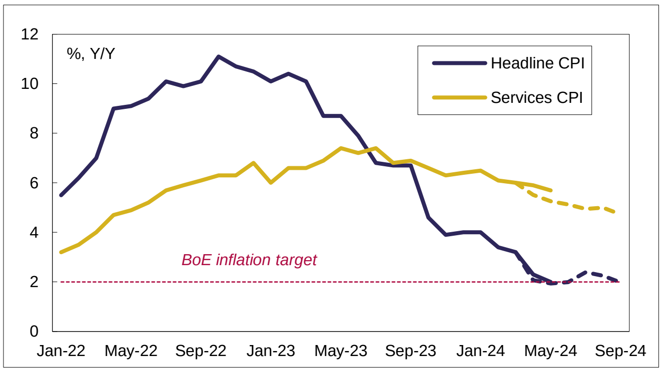
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Selected services inflation components



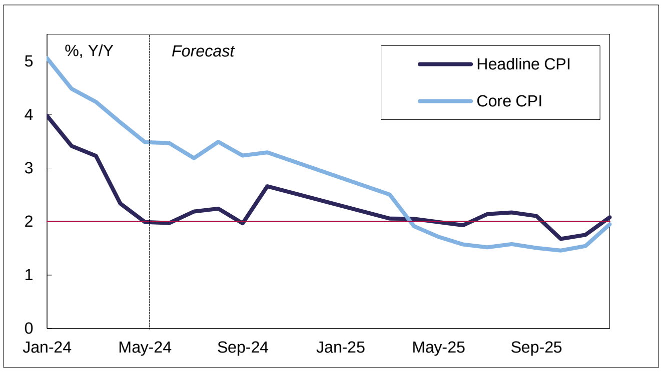
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Headline & services inflation



**Dashed lines represent BoE forecast from May Monetary Policy Report.*
Source: BoE, Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Inflation projection



Source: 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 output M/M% (Y/Y%)	Apr	**-0.2 (-1.1)**	-	0.1 (0.1)	-0.5 (-0.7)
UK		CPI (core CPI) Y/Y%	May	**2.0 (3.5)**	*2.0 (3.4)*	2.3 (3.9)	-
		PPI – input (output) prices Y/Y%	May	**-0.1 (1.7)**	-0.2 (1.7)	-1.6 (1.1)	-1.4 (-)
		House price index Y/Y%	Apr	**1.1**	-	1.8	0.9

Auctions

Country		Auction
Germany		sold €1.63bn of 2039 bonds at an average yield of 2.54%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

Country		BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Euro area		07.00	New car registrations Y/Y%	May	-	12.8
		15.00	Preliminary Commission consumer confidence indicator	Jun	-13.8	-14.3
Germany		07.00	PPI Y/Y%	May	-2.1	-3.3
UK		12.00	BoE Bank Rate %	May	*5.25*	5.25

Auctions and events

Country		BST	Event
Euro area		09.00	ECB Economic Bulletin to be published
France		09.50	Auction: To sell 2.75% 2027 bonds
		09.50	Auction: To sell 5.50% 2029 bonds
		09.50	Auction: To sell 2.75% 2030 bonds
		09.50	Auction: To sell 0% 2032 bonds
		10.50	Auction: To sell 1.85% 2027 index-linked bonds
		10.50	Auction: To sell 0.1% 2036 index-linked bonds
		10.50	Auction: To sell 0.1% 2036 index-linked bonds
		10.50	Auction: To sell 0.1% 2053 index-linked bonds
UK		12.00	BoE monetary policy announcement and minutes to be published

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.