Euro wrap-up

Overview

Chris Scicluna
+44 20 7597 8326

Emily Nicol
+44 20 7597 8331

- Bunds made gains as the flash euro area output PMIs disappointed and the price indices pointed to ongoing disinflation, supporting the case for a further ECB rate cut next month.
- While the UK services activity PMIs improved in May, Gilts also made gains as the price PMIs took a step down to ease concerns about yesterday's upside surprise to inflation in April.
- Friday will bring the latest figures for euro area negotiated wages, UK retail sales and consumer confidence.

Daily bond market movements

Bond	Yield	Change
BKO 1.7 06/27	1.818	-0.045
OBL 2.4 04/30	2.165	-0.026
DBR 2½ 02/35	2.635	-0.008
UKT 3¾ 03/27	4.019	-0.054
UKT 4⅜ 03/30	4.193	-0.042
UKT 4½ 03/35	4.745	-0.009

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

Euro area

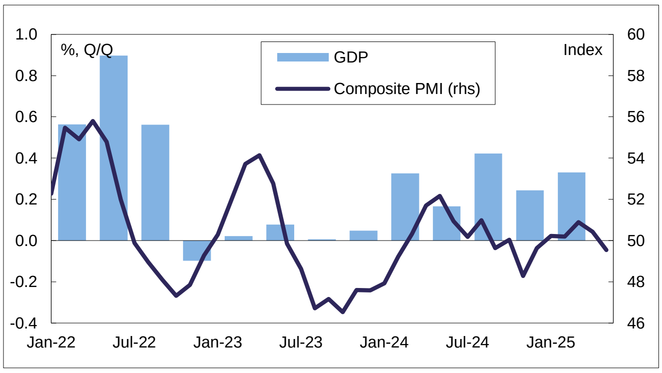
Flash PMIs fall further in May due to deterioration in services

Contrasting the modest improvement in consumer confidence this month, today's flash May euro area PMIs disappointed expectations, suggesting that economic activity weakened in the middle of Q2 to underscore the case for a rate cut at the ECB's 5 June meeting. In particular, the headline euro area composite output PMI fell 0.9pt in May to 49.5, marking the first sub-50 reading this year. And this left the index averaging so far in Q2 around ½pt lower than in Q1, at 50.0, consistent with zero GDP growth this quarter. Nevertheless, while production in many sub-sectors had been front-loaded to Q1 to try to dodge new US tariffs, the manufacturing output index (51.5) was unchanged from April, which had implied the strongest growth in the sector in three years. And the new export order index rose to the highest since level early 2022. But the broadly favourable conditions in the factory sector were offset by a deterioration in services, where the activity index declined for a third month out of the past four. Indeed, the drop of 0.9pt to 48.9 left the index at its lowest level since January 2024 to be trending so far in Q2 some 1½pts below the Q1 average. And firms in the sector were the most downbeat about the coming 12 months in more than 3½ years. The weakness in services was led by the steepest decline in German activity in 16 months. As a result, the German composite PMI fell 1.5pts – the most in 11 months – to 48.6, a five-month low. While the French composite PMI (48.0) was also suggestive of declining GDP, it was trending 1pt above the Q1 average. And although the respective index for the rest of the euro area (51.5) eased to the softest in four months, it still implied ongoing expansion.

German ifo and French INSEE business surveys less downbeat than the PMIs

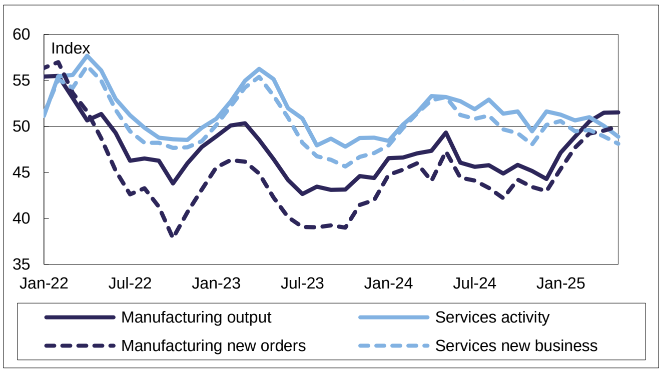
While today's PMIs pointed to renewed contraction in the largest member state, other surveys – including today's ifo business indices – suggest that the German economy is treading water this quarter. Admittedly, like the PMIs, the headline ifo current situation balance edged slightly lower in May due to a worsening in services sentiment. But firms in the other main sectors judged conditions to have improved slightly as orders stabilised. And, overall so far in Q2, the headline ifo index is trending some 0.7pt above the Q1 average. Looking ahead, manufacturers revised up notably their expectations for the coming six months. German firms in the services and retail sectors were similarly the most upbeat about the outlook in a year. And likely buoyed by expectations of further interest rate cuts, constructors were the least pessimistic since February 2022. Meanwhile, in France, the INSEE business survey also suggested that construction firms are far more optimistic about the outlook. But despite signalling the strongest production growth in almost two years, French manufacturers were somewhat more downbeat this month as order books deteriorated. And reflecting a reported slowing in activity in hospitality and information and communications, French services sentiment slipped to a 10-month low, some 5% below the long-run average. Nevertheless, like the French composite PMI, despite easing to a four-month low, the headline INSEE sentiment index was trending marginally above the Q1 average, arguably suggestive of continued modestly positive GDP growth in Q2.

Euro area: GDP growth & composite output PMI



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

Euro area: Services & manufacturing PMIs

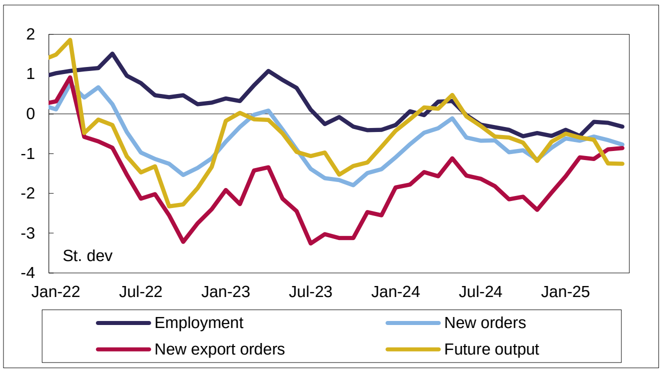


Source: Macrobond, S&P Global and Daiwa Capital Markets Europe Ltd.

Output price PMIs suggest ongoing disinflation similarly supporting case for further ECB easing

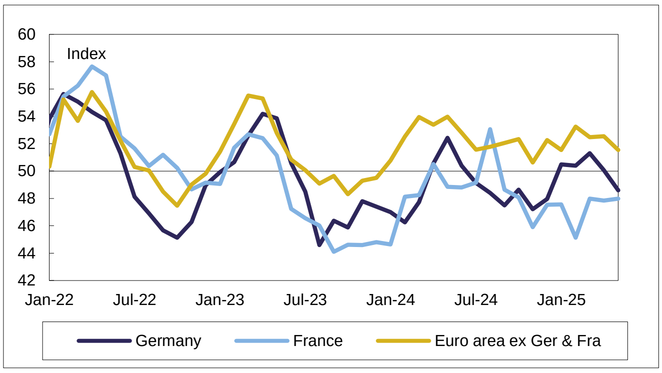
With respect to inflation, most of the news from the flash PMIs was encouraging. Services input costs were reportedly up again at a non-negligible pace similar to that of the past six months. But output prices in the sector slowed for a third successive month with the implied rate of inflation the softest in eight months. Meanwhile, both input costs and output prices in manufacturing fell this month, with the latter down the most so far this year. As a result, overall, the composite input cost PMI edged down to a six-month low. And the composite output price PMI fell almost 1pt to 51.6, broadly in line with the long-run average to be consistent with ongoing underlying disinflation and an eventual return of inflation back to the ECB's target. Today's account of the April policy meeting suggested that Governing Council members already agreed last month "that most indicators were pointing to a sustained return of inflation to the 2% medium-term target." So, today's flash PMIs certainty won't change that judgement. The policymakers also agreed that the "negative demand shock linked to [US] tariff proposals and the related pervasive uncertainty, the appreciation of the euro and the decline in oil and gas prices, would further dampen the inflation outlook in the near term". So, while Governing Council members also recognised some potential sources of upwards pressures on inflation over the medium term, such as German fiscal policy, there seems no good reason not to expect a further cut in the deposit rate to 2.0% at the next meeting on 5 June.

Euro area: Selected composite PMIs



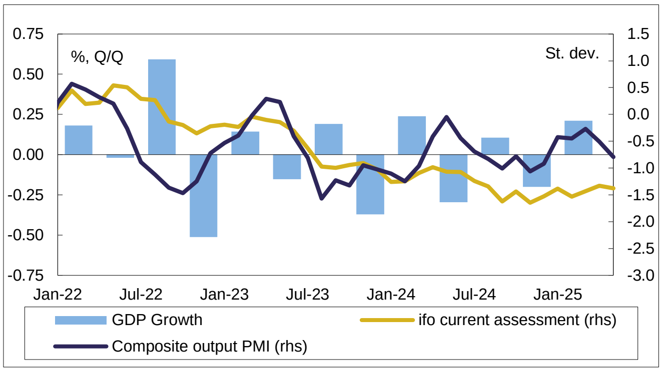
Source: Macrobond, S&P Global and Daiwa Capital Markets Europe Ltd.

Euro area member states: Composite output PMIs



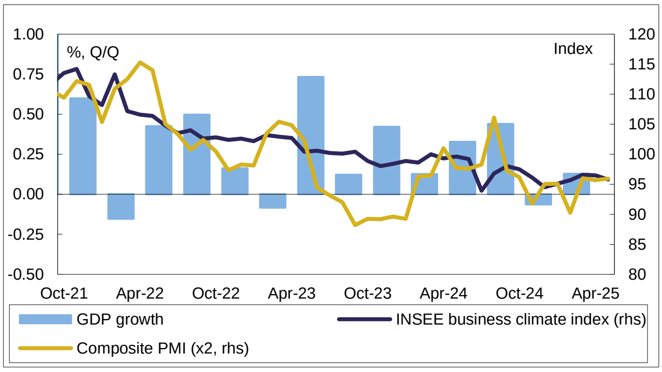
Source: Macrobond, S&P Global and Daiwa Capital Markets Europe Ltd.

Germany: GDP growth & survey indices



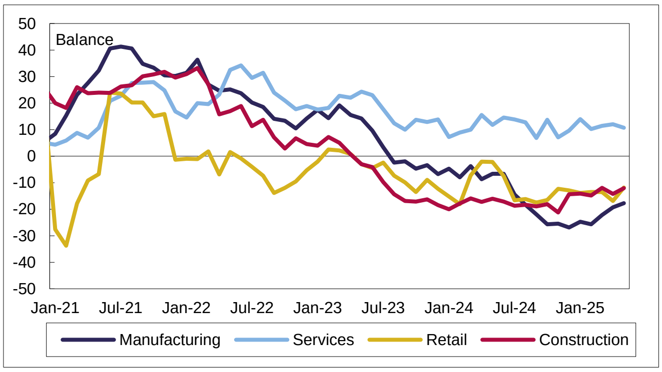
Source: Macrobond, S&P Global and Daiwa Capital Markets Europe Ltd.

France: GDP growth & survey indices



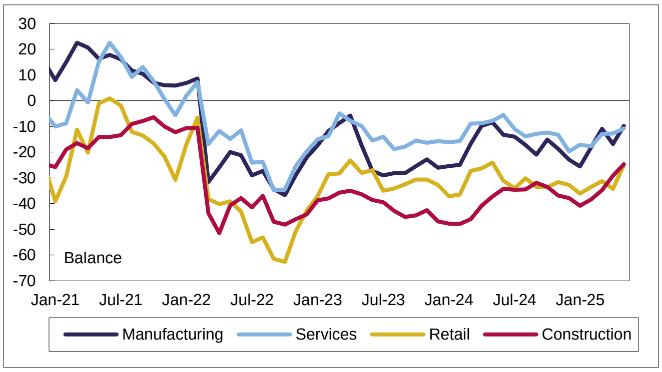
Source: Macrobond, S&P Global and Daiwa Capital Markets Europe Ltd.

Germany: ifo survey – current situation indices



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Germany: ifo survey – expectations indices



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

The day ahead in the euro area

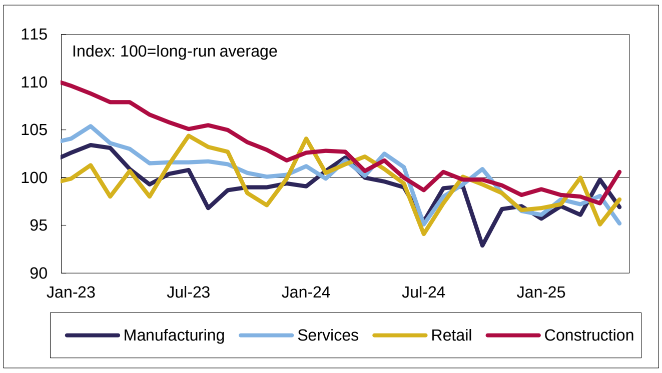
Following on from Tuesday's release of preliminary euro area labour cost data for Q1, Friday's negotiated wage data are expected to reaffirm the softening trend at the start of the year. Indeed, a timelier release from France showed year-on-year settlements slowing 0.6ppt to just 1.8%Y/Y in Q1. Incomplete data from Germany implied a similar pattern, with the Bundesbank reporting today that, helped by a strong increase one year ago, negotiated pay rates rose just 0.9%Y/Y in Q1, versus 5.8%Y/Y at the end of last year. In any case, to the extent that negotiated wages in the euro area remain consistent with implied pathways of the ECB's wage tracker tool – which currently forecasts a more significant deceleration in pay settlements later this year – any temporary stickiness would not trouble the majority on the Governing Council anyway. Meanwhile, final estimates of German GDP in Q1 should confirm the modest rebound in activity in the euro area's largest member state at the start of the year, in line with preliminary estimates for growth of 0.2%Q/Q. The accompanying breakdown by expenditure components is likely to show positive contributions from private consumption and business investment. Comments from ECB Chief Economist Lane, who delivers a lecture on 'inflation and disinflation in the euro area' tomorrow, may also be of interest.

UK

Despite improvement PMIs point to ongoing contraction in May

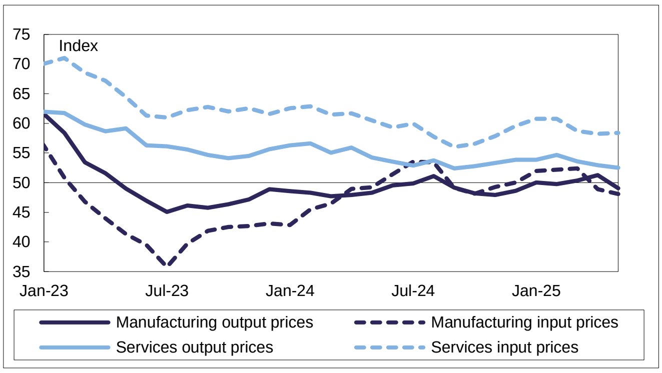
While the flash UK PMIs rebounded in May, today's survey might have done little to change the BoE's expectation of minimal GDP growth in Q2 of around 0.1%Q/Q. As it also signalled a moderation in price pressures this month, today's release might also ease concerns somewhat about yesterday's upside surprise to inflation in April, perhaps renewing confidence in the case for the continued gradual removal of policy restrictiveness. Having reversed only a fraction of the 3pt drop in April, the composite output index (49.4) remained in contractionary territory in May, trending almost 2pts below the Q1 average at a level that before the pandemic would have been consistent with a non-negligible contraction in economic activity. Of course, the PMIs provided a poor guide to GDP growth in Q1, failing to signal the marked acceleration to 0.7%Q/Q. Nevertheless, following the front-loading of production in certain industries in Q1, today's survey unsurprisingly reported renewed weakening in manufacturing in May, with the output component down to a 19-month low (44.8). And while the new export orders index rose to a three-month high, domestic demand remained extremely weak. Admittedly, firms were somewhat more optimistic about the outlook for the coming twelve months, perhaps lifted by the agreement of a new US-UK trade deal this month. Today's survey also signalled an improvement in the UK's dominant services sector in May, with the activity index (50.2) pointing to stagnation rather than renewed retrenchment. And, despite an ongoing decline in demand, firms in the

France: INSEE survey – business climate indices



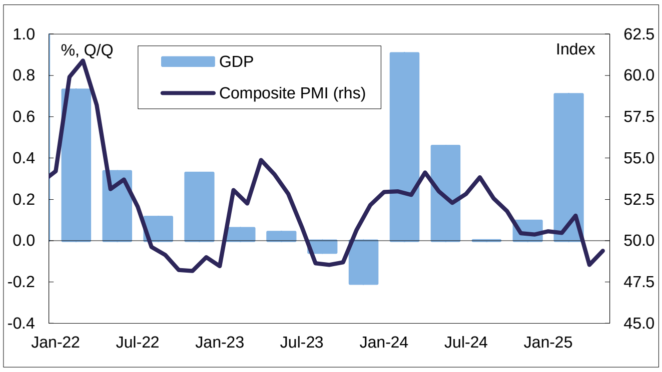
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Price PMIs



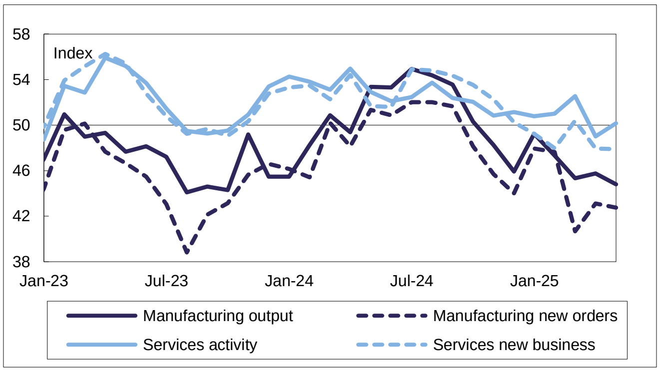
Source: Macrobond, S&P Global and Daiwa Capital Markets Europe Ltd.

UK: GDP growth & composite output PMI



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

UK: Services & manufacturing PMIs



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

sector were the most upbeat about the year ahead since last October. So, while we forecast a modest contraction in GDP in Q2 (-0.1%Q/Q), we also expect GDP to return to moderate expansion in the second half of the year.

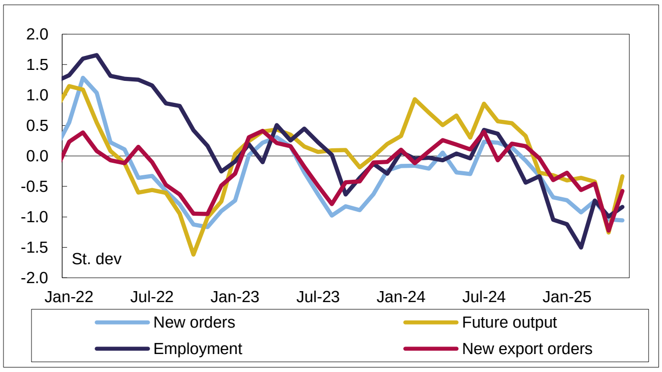
Easing price pressures to support case for gradual removal of policy restrictiveness

This notwithstanding, firms in both the manufacturing and services sectors continued to signal ongoing cuts to headcount, reinforcing signals of a loosening labour market and the likelihood of continued moderation in wage growth. Moreover, firms reported an easing in input costs this month after last month's hikes in the national living wage and employer National Insurance Contributions. And having risen previously to a near-two-year high, the composite output price PMI fell 3½pts to the lowest level this year, with the respective services index (55.3) the softest in seven months and 1pt below the average of the past twelve months.

The day ahead in the UK

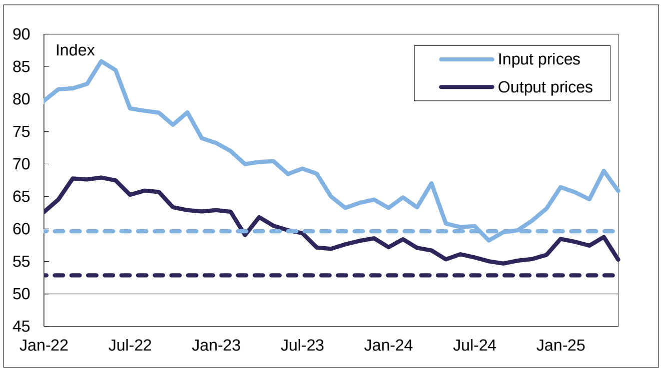
Mirroring the improvement in the PMIs, May's consumer confidence should experience some payback after April's initial trade shock led to a deterioration in that month. The headline index, though likely to improve, will nonetheless remain downbeat. But particular attention will also be paid to major purchase intentions for any adverse impact on consumers' willingness to spend. With respect to the hard data, official retail sales data have proved remarkably resilient, rising for three consecutive months at the start of the year, to be up 1.6%3M/3M in Q1. Four consecutive monthly increases, excluding the pandemic-affected recovery, were last observed 10 years ago. But we, in line with the market consensus, see the risks to April's retail sales figures skewed to the upside. Indeed, record sunshine, as reflected in the strength of the BRC retail survey that month, as well as the timing of Easter holidays would seem likely to support another monthly increase in April.

UK: Selected composite PMIs



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

UK: Services price PMIs*



**Dashed lines represent pre-pandemic average.*
Source: Macrobond, S&P Global 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	Preliminary manufacturing (services) PMI	May	**49.4 (48.9)**	49.2 (50.5)	49.0 (50.1)	-
	Preliminary composite PMI	May	**49.5**	50.6	50.4	-
Germany	Preliminary manufacturing (services) PMI	May	**48.8 (47.2)**	48.8 (49.5)	48.4 (49.0)	-
	Preliminary composite PMI	May	**48.6**	50.3	50.1	-
	ifo business climate indicator	May	**87.5**	87.3	86.9	-
	ifo current assessment (expectations) indicator	May	**86.1 (88.9)**	86.6 (88.0)	86.4 (87.4)	-
France	Preliminary manufacturing (services) PMI	May	**49.5 (47.4)**	48.9 (47.7)	48.7 (47.3)	-
	Preliminary composite PMI	May	**48.0**	48.1	47.8	-
	INSEE business (manufacturing) confidence indicator	May	**96 (97)**	97 (99)	96 (99)	97 (100)
	BdF retail sales Y/Y%	Apr	**0.4**	-	-0.8	-
UK	Preliminary manufacturing (services) PMI	May	**45.1 (50.2)**	46.1 (50.0)	45.4 (49.0)	-
	Preliminary composite PMI	May	**49.4**	49.3	48.5	-
	CBI industrial trends survey – total orders (selling prices) balance %	May	**-30 (26)**	-24 (22)	-26 (23)	
	Public sector net borrowing £bn	Apr	**20.2**	17.3	16.4	14.1

Auctions

Country	Auction
France	sold €3.94bn of 2.4% 2028 bonds at an average yield of 2.3%
	sold €6.102bn of 2.7% 2031 bonds at an average yield of 2.72%
	sold €2.455bn of 0% 2032 bonds at an average yield of 2.91%
	sold €964m of 0.1% 2031 inflation-linked bonds at an average yield of 0.83%
	sold €379m of 3.15% 2032 inflation-linked bonds at an average yield of 0.91%
	sold €255m of 1.8% 2040 inflation-linked bonds at an average yield of 1.58%
	sold €380m of 0.1% 2053 inflation-linked bonds at an average yield of 1.73%
Spain	sold €1.821bn of 5.15% 2028 bonds at an average yield of 2.251%
	sold €2.754bn of 3.1% 2031 bonds at an average yield of 2.75%
	sold €1.647bn of 1% 2042 bonds at an average yield of 3.847%

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	Negotiated wages Y/Y%	Q1	-	4.1
Germany	07.00	GDP – final estimate Q/Q% (Y/Y%)	Q1	*0.2 (-0.2)*	-0.2 (-0.2)
France	07.45	INSEE consumer confidence indicator	May	93	92
UK	00.01	GfK consumer confidence indicator	May	-22	-23
	07.00	Retail sales – incl. auto fuel M/M% (Y/Y%)	Apr	0.3 (4.5)	0.4 (2.6)
	07.00	Retail sales – excl. auto fuel M/M% (Y/Y%)	Apr	0.1 (4.4)	0.5 (3.3)

Auctions and events

Country	BST	Event
Euro area	09.30	ECB Chief Economist Lane gives lecture on "inflation and disinflation in the euro area" at EMU Lab, Florence

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Access our research blog at:
https://www.uk.daiwacm.com/ficc-research/recent-blogs