

Euro wrap-up

Overview

- Bunds made gains as flash May euro area inflation estimates fell more than expected, with headline inflation back below the 2% target and the core HICP rate the lowest since January 2022.
- Gilts also made gains after MPC members suggested that the outcome of the BoE's summer review of QT is uncertain, while Governor Bailey stated the MPC might need to cut rates faster if wage growth slowed more significantly.
- Wednesday will bring the final May services PMI surveys from the euro area and UK.

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Daily bond market movements

Bond	Yield	Change
BKO 1.7 06/27	1.769	-0.016
OBL 2.4 04/30	2.065	-0.017
DBR 2½ 02/35	2.506	-0.017
UKT 3% 03/27	4.008	-0.007
UKT 4% 03/30	4.130	-0.027
UKT 4½ 03/35	4.627	-0.037

*Change from close as at 4:40pm BST.

Source: Bloomberg

Euro area

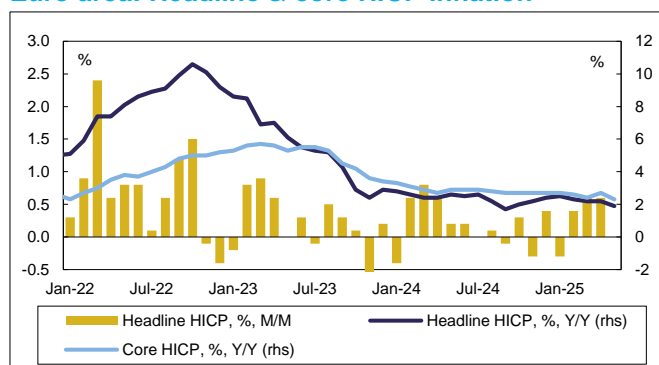
Flash inflation falls more than expected in May, justifying the inevitable further rate cut on Thursday

Today's flash May estimates of euro area inflation further underscored the inevitability that the Governing Council on Thursday will deliver an eighth cut this cycle of 25bps, taking the deposit rate to a 29-month low of 2.00%. In particular, headline HICP inflation moderated a larger-than-expected 0.3ppt in May to 1.9%Y/Y, the lowest since October and just the third sub-2% target reading since mid-2021. Inflation was also below target in member states accounting for more than 50% of the region's GDP including France, Italy and Spain. And the drop in May left the euro area headline rate trending so far in Q2 some 0.2ppt below the ECB's March macroeconomic projection, further illustrating the case for a downwards revision when its updated forecasts are published alongside its policy announcement this week. There was also a welcome moderation in core HICP inflation in May, down a chunky 0.4ppt to 2.3%Y/Y, the lowest since January 2022. But given the sharp uptick in April, core inflation was still trending in the first two months of Q2 some 0.2ppt above the ECB's previous projection suggesting the risk of a modest upwards revision in this rate on Thursday.

Services inflation falls to a more than 3-year low, offsetting uptrend in food inflation

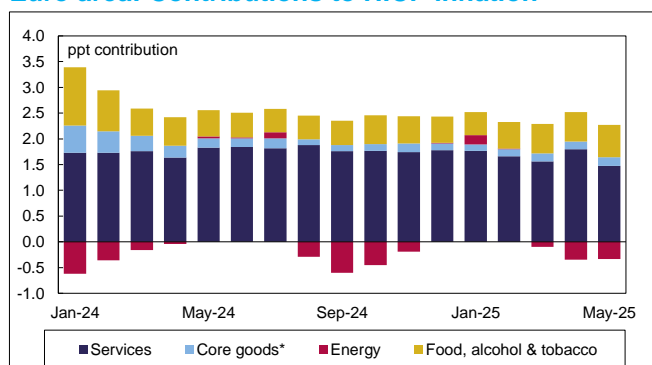
Within the detail, the moderation in May was predictably led by services inflation, which fell a hefty 0.8ppt – the most in 20 months – to 3.2%Y/Y, the softest rate since April 2022. While today's data provided no further breakdown, national releases point to a marked decline in package holidays and airfares as prices normalised after sharp increases over the Easter holiday period. Indeed, on a seasonally adjusted basis, the ECB's data reported the steepest monthly drop in services prices (-0.2%M/M) in any May on the series, which followed the record increase for April, illustrating the failure to adequately adjust for the distortion caused by the change in timing of Easter. Indeed, on this basis, services momentum was little improved in May, at 4.0%3M/3M annualised, still in line with the average in 2024 and some 1½ppts above January's trough. But not least reflecting more favourable base effects and with pricing powers constrained in the face of subdued demand in the core member states, we expect services inflation to ease further to 3%Y/Y or below over coming months. Today's release also showed an ongoing absence of core goods price pressures, with inflation of this component steady at 0.6%Y/Y for a fourth consecutive month in May, while momentum moderated to a very soft ten-month low (0.4%3M/3M ann.). The weaker demand outlook, as well as the stronger euro exchange rate, will also weigh on core goods prices over the near term. Among the non-core components, energy (-3.6%Y/Y) remained a drag on headline inflation for a third successive month in May. But given less favourable base effects this might now mark the trough. And some of the more hawkish Governing Council members might be concerned about the further steady uptrend in food inflation, which rose to a 15-month high (3.3%Y/Y) amid a further increase in prices of processed food.

Euro area: Headline & core HICP inflation



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Contributions to HICP inflation



*Non-energy industrial goods.

Source: Macrobond and Daiwa Capital Markets Europe Ltd.

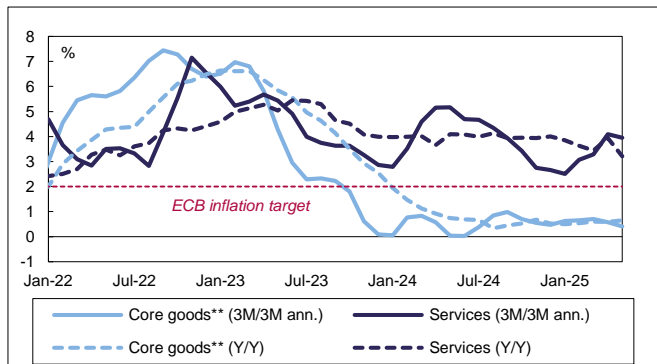
Euro area unemployment rate matches series low, reinforcing labour market resilience

After this week's rate cut, the various Governing Council members will have differing assessments of the stance of monetary policy. Some might assess it to be still slightly restrictive, while others will consider it to be broadly neutral or even slightly accommodative. As such, in the absence of new adverse shocks, we expect the Governing Council to reach a consensus to avoid a further change to policy in July before taking stock of the impact of its recent rate cuts in September and only then deciding whether or not to adjust policy further. One reason why the Governing Council will feel able to be patient is the persisting resilience of the labour market. Indeed, while surveys have signalled greater willingness to cut headcount, euro area unemployment fell a sizeable 207k in April – the most since September 2021 – to 10.68mn. This pushed the jobless rate down 0.1ppt to match the series low of 6.2% recorded in Q424. The improvement largely reflected a near-100k drop in French unemployment, taking the rate down 0.3ppt to a more-than 2-year low of 7.1%. The Italian unemployment rate reversed the uptick in March to match February's rate (5.9%), just 0.1ppt above the series low recorded in April 2007, while the Greek (8.3%) rate fell to the lowest since 2008. Although the Spanish rate (10.9%) moved sideways, today's national labour market figures reported a further decline in jobless claims in May to the lowest level since mid-2008. In contrast, although the German ILO unemployment rate held steady in April (3.6%), the claimant count rose in May by the most in six years flagging the risks of a slight pickup in the euro area unemployment rate heading into summer.

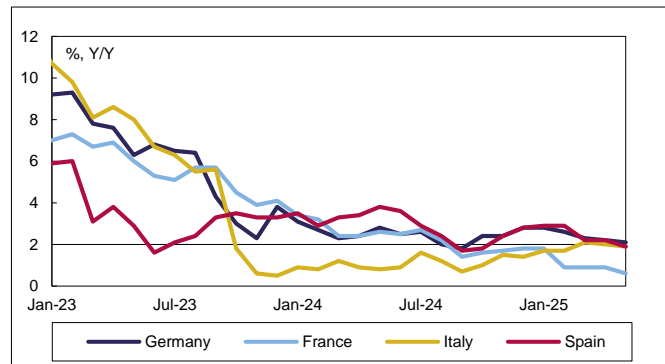
The day ahead in the euro area

As the Governing Council convenes ahead of Thursday's monetary policy announcement, May's final composite and services PMIs will be the focus of Wednesday's economic dataflow from the euro area. Having weakened slightly in April, May's flash release was more downbeat, with the composite output PMI slipping into modest contraction territory (49.5) for the first time since the end of last year. That also left the composite index trending at 50.0 for the latest two months, suggesting that private sector activity had stagnated in Q2. That might have been expected, given the turmoil of trade uncertainty. But Monday's final manufacturing survey suggested that output growth in that sector was surprisingly stable in May, displaying its fastest expansion (51.5) since the energy price shock three years prior. Services, by contrast, saw a more pronounced drop. Led by a sharper fall in Germany, the flash services survey suggested that activity in the sector in the euro area slipped into contractionary territory in May, to a 16-month low of 48.9. Tomorrow's final euro, German and French PMIs will also be accompanied by Italian and Spanish data.

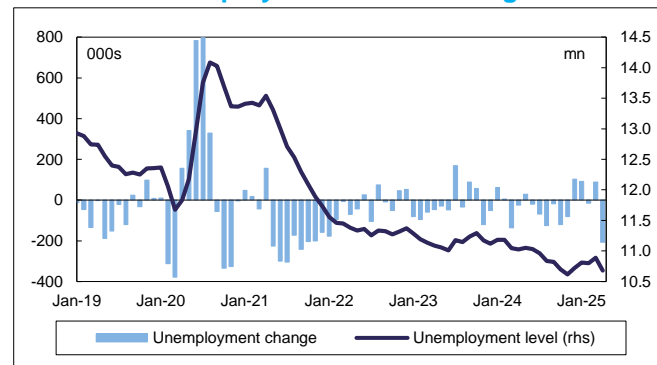
Euro area: Core inflation momentum*



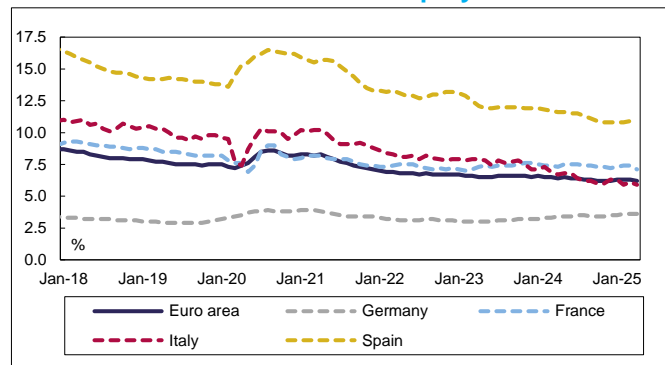
Euro area member states: HICP inflation



Euro area: Unemployment level & change



Euro area member states: Unemployment rate



The day ahead in the UK

Like the euro area, May's final PMIs will be tomorrow's sole data event in the UK. The possibility of an improvement in tomorrow's UK final composite PMI would appear buoyed after May's manufacturing output was marked up from the flash release, signalling a slightly slower rate of contraction with the respective index at a three-month high of 46.5. Still, while signalling an improvement from April's sudden deterioration, May's composite output PMI will continue to imply a notable slowdown in private sector activity in Q2. Indeed, despite steady improvement in the manufacturing sector this quarter, the dominant services sector has underscored the recent PMI weakness. And while the flash saw a modest 1.2pts recovery in that sector's activity last month (to 50.2), that still represents a 1.6pts shortfall on Q1's average, to be broadly consistent with stagnation. But, in addition to the output and demand measures, final price and employment indices will also be in focus. The flash release was arguably more optimistic with respect to assessments of underlying price persistence, flagging significant drops across the input and output prices PMIs, albeit coming off the back of April's recent peak. Output prices, for example, reported their sharpest drop since the pandemic lockdowns, shedding 3.5pts to a five month low of 55.4.

European calendar

Today's results

Economic data

Country	Release	Period	Actual	Market consensus/ <i>Daiwa forecast</i>	Previous	Revised
Euro Area	Preliminary headline (core) HICP Y/Y%	May	1.9 (2.3)	<u>2.0 (2.5)</u>	2.2 (2.7)	-
	Unemployment rate %	Apr	6.2	<u>6.2</u>	6.2	6.3
Spain	Unemployment (net employment) M/M change 000s	May	-57.8 (20.8)	-	-67.4 (69.2)	-

Auctions

Country	Auction
Germany	sold €3.678bn of 1.7% 2027 bonds at an average yield of 1.78%
UK	sold £1.25bn of 4% 2063 bonds at an average yield of 5.281%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Monday's results

Economic data







Country	Release	Period	Actual	Market consensus/ <i>Daiwa forecast</i>	Previous	Revised
Euro Area	Final manufacturing PMI	May	49.4	<u>49.4</u>	49.0	-
Germany	Final manufacturing PMI	May	48.3	<u>48.8</u>	48.4	-
France	Final manufacturing PMI	May	49.8	<u>49.5</u>	48.7	-
Italy	Manufacturing PMI	May	49.2	49.6	49.3	-
Spain	Manufacturing PMI	May	50.5	48.4	48.1	-
UK	Net consumer credit £bn (Y/Y%)	Apr	1.6 (6.7)	1.2 (-)	0.9 (6.1)	1.1 (6.2)
	Net mortgage lending £bn (mortgage approvals 000s)	Apr	-0.8 (60.5)	1.4 (62.8)	13.0 (64.3)	- (63.6)
	Final manufacturing PMI	May	46.4	<u>45.1</u>	45.4	-
	Nationwide house price index M/M% (Y/Y%)	May	0.5 (3.5)	0.0 (2.8)	-0.6 (3.4)	-

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 	09.00	Final composite (services) PMI	May	<u>49.5 (48.9)</u>	50.4 (50.1)
Germany 	08.55	Final composite (services) PMI	May	<u>48.6 (47.2)</u>	50.1 (49.0)
France 	08.50	Final composite (services) PMI	May	<u>48.0 (47.4)</u>	47.8 (47.3)
Italy 	08.45	Composite (services) PMI	May	51.4 (52.0)	52.1 (52.9)
Spain 	08.00	Industrial production M/M% (Y/Y%)	Apr	=	0.9 (1.0)
	08.15	Composite (services) PMI	May	52.3 (52.9)	52.5 (53.4)
UK 	09.30	Final composite (services) PMI	May	<u>49.4 (50.2)</u>	48.5 (49.0)

Auctions and events

UK 	10.00	Auction: to sell £4.75bn of 4.375% 2028 bonds			
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Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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