Euro wrap-up

Overview

Emily Nicol
+44 20 7597 8331

Edward Maling
+44 20 7597 8030

- While the final PMIs were consistent with a further weakening in euro area economic activity, Bunds made modest losses as the German cabinet approved a tax incentive package to boost business capex.
- Gilts followed USTs higher as the UK PMIs pointed to stagnation and easing price pressures.
- On Thursday, the ECB will cut the deposit rate by 25bps to 2.00% as near-term inflation and growth projections are revised lower, but President Lagarde will remain non-committal about future policy path.

Daily bond market movements

Bond	Yield	Change
BKO 1.7 06/27	1.786	+0.011
OBL 2.4 04/30	2.093	+0.013
DBR 2½ 02/35	2.524	+0.001
UKT 3¾ 03/27	3.996	-0.019
UKT 4⅜ 03/30	4.110	-0.026
UKT 4½ 03/35	4.604	-0.031

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

Euro area

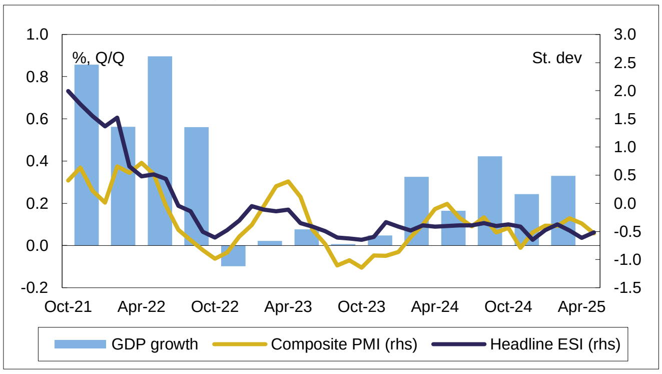
Final PMIs consistent with stagnation despite upwards revision from the flash survey

Contrasting the pickup in the Commission's economic sentiment index, and despite a sizeable upwards revision from the flash release, today's final May PMIs implied a further weakening in euro area economic activity this quarter. The revision to the headline composite PMI of 0.7pt was well above the average for the past year (0.2pt), suggesting that the final 17% of businesses to complete the survey between 20-25 May assessed conditions to be notably more favourable than earlier in the month. But, at 50.2, the composite index still marked a three-month low and was consistent with zero GDP growth this quarter, following the tariff-related acceleration in Q1 (0.3%Q/Q). And the composite PMI would have been lower still in the absence of signals of ongoing expansion in factory production, for which the respective PMI (51.5) was unchanged from April. That level implied the strongest growth in the sector in three years, despite the front-loading of output and shipments to the US in Q1 in certain sub-sectors, most notably pharmaceuticals. Indeed, while the services activity PMI (49.7) was revised 0.8pt higher than the preliminary reading, this still marked the weakest level since November. Furthermore, that index was trending in the first two months of Q2 more than 1pt below the Q1 average, tallying with the findings of the Commission's services survey, and flagging the likely knock to domestic demand this quarter from heightened economic uncertainties.

French and Italian PMIs surprise to the upside, but Spanish & German indices deteriorate

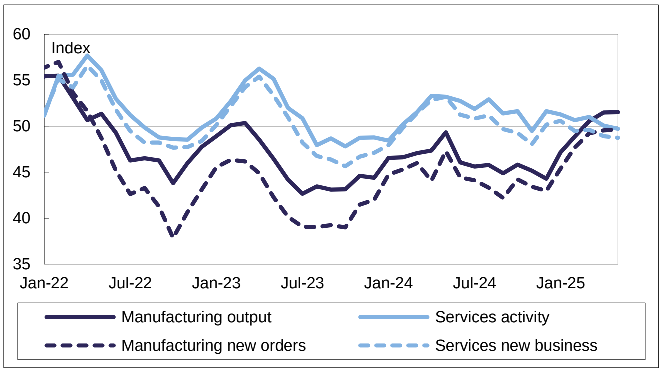
As is often the case, the French survey underpinned the revision in the final May PMIs. Indeed, the French composite PMI (49.3) – up 1.3pts from the flash – was the strongest since August, with the services index (48.9) also up to a five-month high. There was a further improvement in the Italian PMIs too, for which the composite index (52.5) rose to the highest since April 2024, pointing to ongoing resilience in GDP growth this quarter. Certainly, the implied expansion in the Italian services sector (53.2) was well above the average of the past two years and, like the composite PMI, the index was the firmest of the member states. In contrast, one disappointment in today's survey related to Spain, where firms considered conditions to be the least favourable since end-2023. Indeed, the respective composite PMI fell for a third consecutive month, by 1pt to 51.4, some 5½pts below the peak in September and trending almost 2½pts below the Q1 average. Admittedly, this remains bang in line with the long-run average and comfortably in expansionary territory. Moreover, the deterioration in the PMI last month contradicts the Commission's Spanish ESI (103.4), which remained well above the long-run average, trending broadly sideways from the Q1 average and suggesting ongoing economic outperformance among the larger member states. The Commission survey and PMIs also provided differing assessments of the German economy. For example, while the ESI rose to a ten-month high in May, the composite PMI (48.5) fell to a five-month low, almost 3pts below March's recent peak. But counter to expectations, this reflected a marked deterioration in the services activity index – to the lowest since November 2022 – while the manufacturing survey was consistent with ongoing expansion.

Euro area: GDP growth & survey indices



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

Euro area: Services & manufacturing output PMI



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

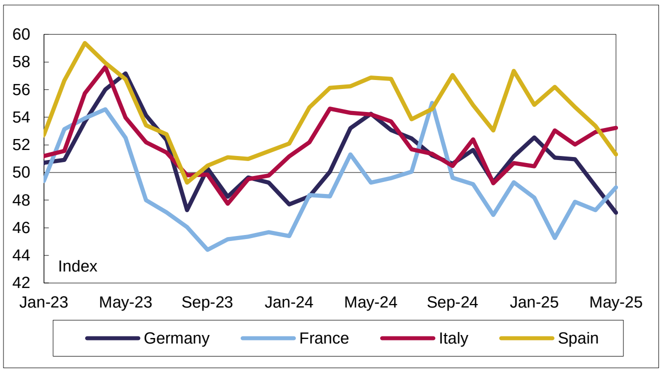
German tax incentive package should provide welcome impetus to business capex

Notwithstanding the mixed survey messages, we expect German GDP to dip slightly in Q2 due to payback from the front-running of US tariffs in Q1. But we expect a steady pickup in economic activity through the second half of the year, supported in part by the German government's package of corporate tax breaks – worth around €46bn – that was adopted by the cabinet today. The measures mark the first constructive step from the new government to shifting momentum in the German economy and include a new depreciation rule allowing firms to offset 30% of the acquisition cost of new machinery, equipment or vehicles purchased between 1 July 2025 and 31 December 2027 for three years. There will also be additional depreciation benefits (75%) for firms acquiring electric vehicles for their fleet, with the gross price limit increasing by €30k to €100k. The government also plans to increase its tax-deductible research allowance to promote R&D investment. And the planned gradual reduction in the corporate tax rate in 2028, by 1ppt a year for five years to just 10%, should push the total corporate tax burden in 2032 to under 25%, broadly in line with OECD average. The coalition aims to secure approval by both the Bundestag and Bundesrat before the summer break in mid-July after which attention should shift to implementing pledges to boost public infrastructure and military spending and deliver further stimulus measures in the 2025 Budget.

Bulgaria given green light from Commission to adopt the euro from 1 January 2026

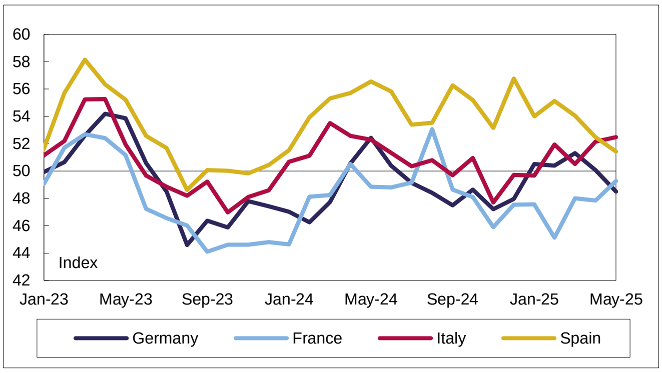
Finally, as expected, the European Commission today recommended that Bulgaria – the EU's poorest member state – should be allowed to join the single-currency bloc as the twenty-first euro area member state from 1 January 2026. Today's convergence report suggested that Bulgaria only barely met the price stability criterion. Indeed, having averaged 8.6%Y/Y in 2023 and moderated to 2.6%Y/Y in 2024, the annual Bulgarian inflation rate over the twelve months to April (2.7%Y/Y) edged just 0.1ppt below the reference value – defined as 1.5ppts above the average of the three member states with the lowest rates. Bulgaria also met the criteria with respect to public finances, conveniently recording a budget deficit of exactly 3.0% of GDP in 2024 – i.e. precisely at the reference level – with it forecast to narrow slightly to 2.8% of GDP this year and next. And while the debt-to-GDP ratio has widened over recent years, at 24.1% in 2024 it remains a long way below the 60% limit and a level that will be the envy of most euro area governments. As such, at the 26-27 June summit, EU leaders look highly likely to give the green light for final approval by finance ministers on 8 July. But with the ECB unsurprisingly flagging concerns about documented shortcomings in the authorities' efforts to tackle financial crime, Bulgaria's approval will not be without political controversy.

Euro area member states: Services activity PMIs



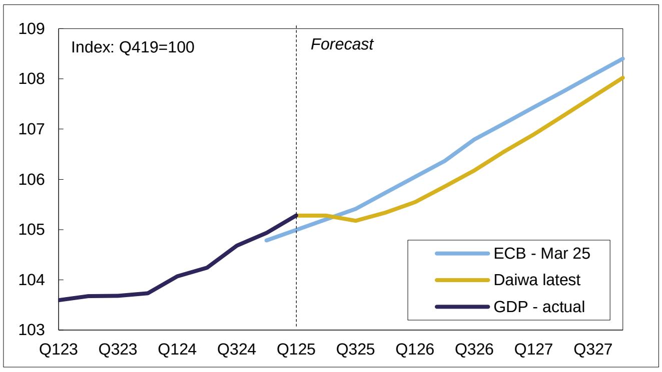
Source: Macrobond, S&P Global and Daiwa Capital Markets Europe Ltd.

Euro area member states: Composite output PMIs



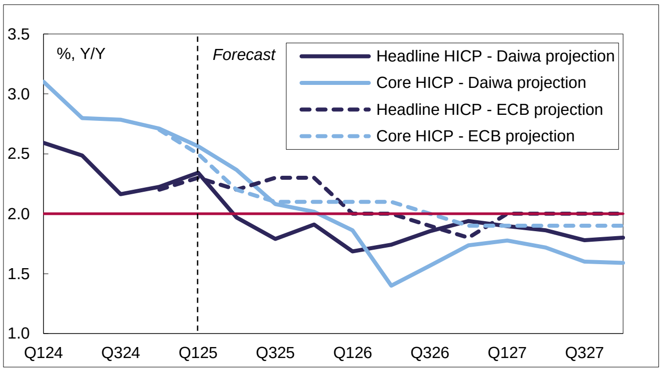
Source: Macrobond, S&P Global and Daiwa Capital Markets Europe Ltd.

Euro area: GDP level projections



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Headline HICP inflation projections



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

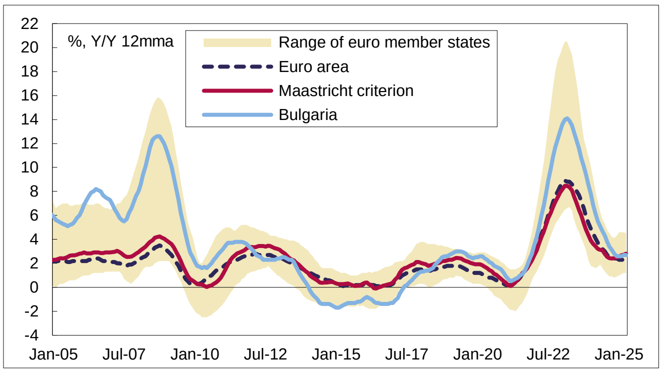
ECB poised for an eighth-consecutive cut but to be non-committal about future easing

Set up by Tuesday's inflation undershoot, a further 25bps rate cut from the Governing Council now looks cemented. Indeed, while the incoming data has continued to broadly signal ongoing disinflation, tomorrow's meeting will surely see the ECB revise down its inflation projection, not least reflecting significant exchange rate appreciation and lower wholesale energy prices. And reflecting both the front-loading of production in certain sectors in Q1, and updated assumptions about US tariff rates, it will surely nudge down its near-term profile for GDP growth too. But the Governing Council's forward guidance will underscore that the economic outlook remains exceptionally uncertain, not least owing to the flux in US trade policies. So, it will restate that policy will be determined on a data dependent and meeting-by-meeting basis. We would also not be surprised if President Lagarde's press conference remarks were to suggest that – conditional on positive developments regarding EU-US trade negotiations – the Governing Council might opt to wait to take stock of the impact of the cumulative easing to date before adjusting policy further. The implication could be that next month's meeting might not be 'live' for another cut, and perhaps also that the end of the easing cycle is in sight. Indeed, with some Governing Council members likely to be enervated by plans by member states, particularly Germany, to ease fiscal policy, the next round of projection updates in September might ultimately determine whether – as we still expect – the ECB that month cuts the deposit rate further to 1.75%, or whether 2.00% will be the terminal rate for this cycle. For our full look ahead to tomorrow's decision, please see last Friday's Euro wrap-up.

The data day ahead in the euro area

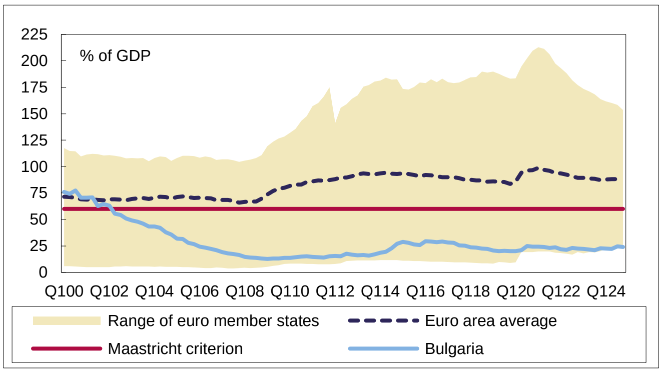
The ECB announcement will inevitably mean that Thursday's economic data will take a back seat. Nonetheless, ahead of Friday's release of German IP figures, April's factory orders will surely draw attention as a first official signposting about manufacturing demand following the US trade announcements that month. As March's orders (up 3.6%M/M) were flattered somewhat by orders for pharmaceutical and machinery products –among the principal beneficiaries of US frontloading efforts – a decline in April seems most probable. But we note that, as well as flagging resilience in manufacturing output, the PMIs in that month similarly showed no deterioration in new orders, while new export orders actually rose to surpass the 50-threshold for the first time since February 2022. Accompanying manufacturing turnover figures will also give more insights into Friday's data. Meanwhile, euro area PPI figures should show that input costs continued to ease in April. That softness will owe to lower energy costs, with goods price pressures otherwise remaining distinctly absent for the time being. Some focus will also have to be paid to final (and often-revised) estimates for Irish GDP in Q4. Boosted by exceptional exports of pharma-related goods to the US, preliminary estimates of growth (3.2%Q/Q) added some 0.12ppt to the aggregate euro area figures. We see the risks of a revision to Irish GDP as to the upside, given the strength of March's exports growth (7.5%M/M). But barring major changes, we expect it to confirm that euro area growth will be revised back up to 0.4%Q/Q at

Average HICP inflation by member state



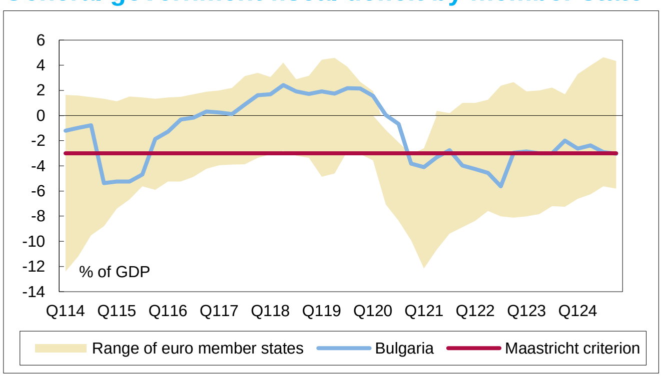
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

General government gross debt by member state



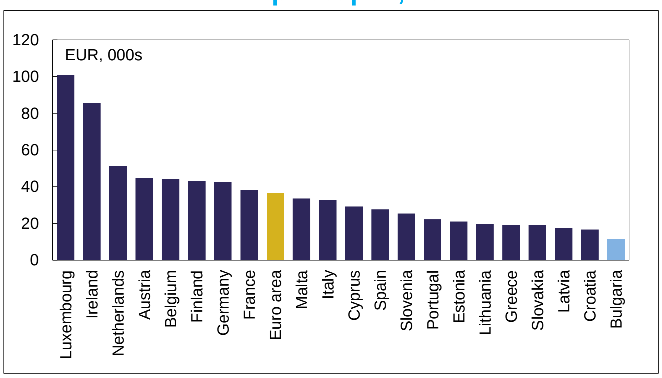
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

General government fiscal deficit by member state



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Real GDP per capita, 2024



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

the end of the week. May's construction PMIs are also due. (7.5%M/M). But barring major changes, we expect it to confirm that euro area growth will be revised back up to 0.4%Q/Q at the end of the week. May's construction PMIs are also due.

UK

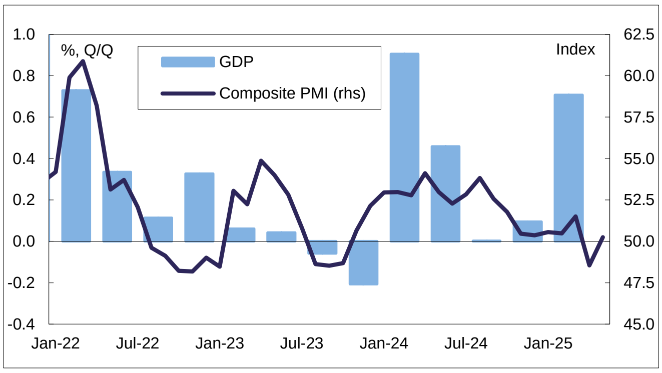
Composite PMI points to stagnation & easing price pressure despite modest services expansion

Like in the euro area, today's final UK composite PMI was revised higher from the preliminary release, by 0.9pt to 50.3. This left the index some 1.7pts above the April reading, but nevertheless still trending some 1½pts below the Q1 average, implying a marked slowdown in GDP in Q2 – perhaps of zero growth at best – following the surprise acceleration in Q1 (0.7%Q/Q). Despite a sizeable improvement in the manufacturing survey from the flash estimate, in contrast to the euro area, the factory output index (46.4) remained firmly in contractionary territory for an eighth consecutive month, while factory orders continued to fall (44.8) despite a softer pace of decline in new export orders. An upwards revision to the services activity index (50.9) was consistent with modest expansion in the sector, with firms reportedly citing improved business and consumer optimism following the tariff-related slump in April, while new marketing initiatives and competitive pricing strategies provided a boost. This notwithstanding, new business (48.7) in the sector reportedly remained weak, adding to ongoing challenges from squeezed margins. In this respect, the survey was more encouraging, suggesting a moderation in cost burdens in May. Nevertheless, firms in both the services and manufacturing sectors continued to cut headcount, providing further evidence of a slowing labour market. Indeed, the composite employment PMI (47.2) recorded the eighth successive sub-50 reading for the first time since 2008-10 outside of the first year of the pandemic. BoE officials ought also be encouraged by signs of moderating inflation pressures, with the output price PMI reporting the sharpest drop since the pandemic lockdowns, down 3.5pts to a five-month low of 55.4.

The day ahead in the UK

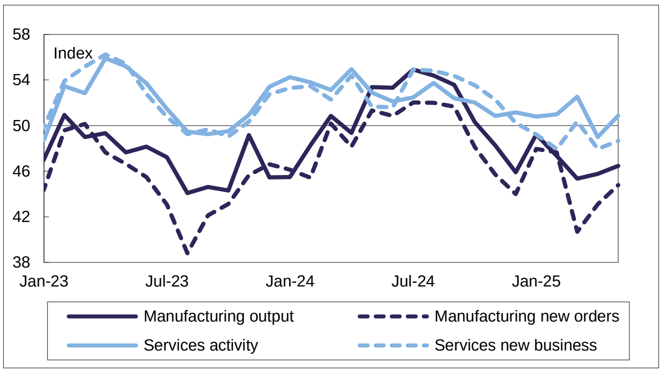
May's round of the BoE's Decision Maker Panel survey will provide the key data release in the UK tomorrow. Certainly, amid the long-standing issues affecting the reliability of conventional labour force statistics, and as inferred by comments by rate setters at yesterday's Treasury Select Committee hearing, a number of MPC members continue to attach weight to the DMP when forming assessments of wage- and price-setting dynamics. To that extent, April's survey results will have been encouraging, as moderation in output price and inflation expectations were accompanied by the softest current and forward-looking wage growth measures for three years. Bearing in mind April's hotter-than-expected CPI print, the BoE will hope to see inflation expectations remain well-behaved, as well as uninterrupted deceleration in wage growth measures. But a more pronounced slowdown, as well as further softening in price expectations would serve to challenge the stance of some MPC

UK: GDP growth & composite output PMI



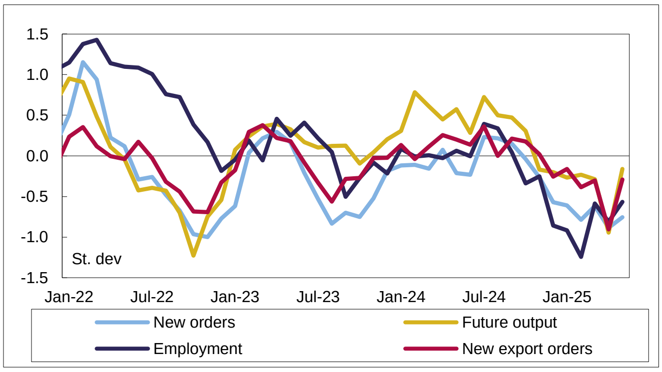
Source: Macrobond, S&P Global and Daiwa Capital Markets Europe Ltd.

UK: Services & manufacturing output PMIs



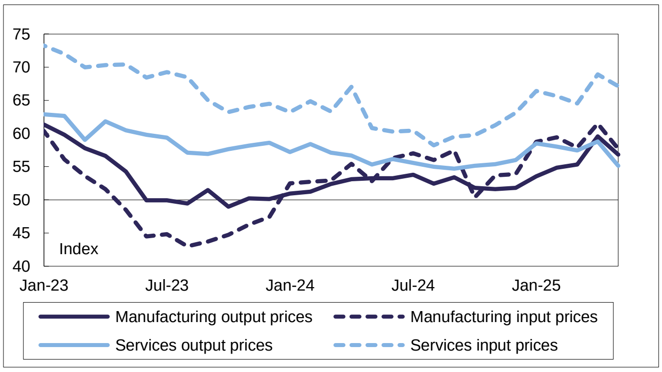
Source: Macrobond, S&P Global and Daiwa Capital Markets Europe Ltd.

UK: Selected composite PMIs



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

UK: Price PMIs



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

members who favoured a pause to quarterly rate cuts at last month's MPC meeting. Elsewhere, May's construction PMIs will provide an update on activity in that sector. Since declining sharply at the start of the year, the PMIs have flagged a persistent contraction in the sector. And with regards to speaking arrangements, comments from BoE Deputy Governor Breeden and MPC External Member Greene on Thursday morning may also be of interest.

European calendar

Today's results

Economic data

Country	Release	Period	Actual	Market consensus/ *Daiwa forecast*	Previous	Revised
Euro Area	Final composite (services) PMI	May	**50.2 (49.7)**	*49.5 (48.9)*	50.4 (50.1)	-
Germany	Final composite (services) PMI	May	**48.5 (47.1)**	*48.6 (47.2)*	50.1 (49.0)	-
France	Final composite (services) PMI	May	**49.3 (48.9)**	*48.0 (47.4)*	47.8 (47.3)	-
Italy	Composite (services) PMI	May	**52.5 (53.2)**	- (52.1)	52.1 (52.9)	-
Spain	Industrial production M/M% (Y/Y%)	Apr	**-0.8 (0.6)**	-	0.9 (1.0)	- (0.9)
	Composite (services) PMI	May	**51.4 (51.3)**	52.2 (53.0)	52.5 (53.4)	-
UK	Final composite (services) PMI	May	**50.3 (50.9)**	*49.4 (50.2)*	48.5 (49.0)	-

Auctions

Country	Auction
UK	sold £4.75bn of 4.375% 2028 bonds at an average yield of 4.062%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

Country	BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Euro Area	08.30	Construction PMI	May	-	46.0
	10.00	PPI Y/Y%	Apr	1.2	1.9
	13.15	ECB Deposit (Refinancing) Rate %	Jun	*2.00 (2.15)*	2.25 (2.40)
Germany	07.00	Factory orders M/M% (Y/Y%)	Apr	-1.5 (3.9)	3.6 (3.8)
	08.30	Construction PMI	May	-	45.1
France	08.30	Construction PMI	May	-	43.6
Italy	08.30	Construction PMI	May	-	50.1
	09.00	Retail sales M/M% (Y/Y%)	Apr	-	-0.5 (-2.8)
UK	09.00	New car registrations Y/Y%	May	-	-10.4
	09.30	Construction PMI	May	47.3	46.6
	09.30	DMP 3M output price (1Y CPI) expectations Y/Y%	May	3.8 (3.2)	3.8 (3.1)

Auctions and events

Country	BST	Event
Euro Area	13.15	ECB monetary policy announcement
	13.45	ECB President Lagarde to hold post-Governing Council meeting press conference, Frankfurt
	14.45	ECB to publish updated macroeconomic projections
France	09.50	Auction: to sell up to €12bn of 3.2% 2035, 1.25% 2036 & 3.75% 2056 bonds
Spain	09.30	Auction: to sell 2.4% 2028, 2.7% 2030, 0.7% 2032 bonds & 2.05% 2039 inflation-linked bonds
UK	08.45	BoE MPC External Member Greene to give opening remarks to ECONDAT conference, London
	09.30	BoE Deputy Governor Breeden to speak in Odgers webinar on 'H2 economic trends'

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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