Daiwa Capital Markets

Euro wrap-up

Overview

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- Bunds made gains as the final estimates of euro area inflation in May reaffirmed that underlying price pressures continue to ease.
- Gilts also made gains as UK inflation fell back thanks to a moderation in the all-important services component.
- The BoE will leave Bank Rate unchanged on Thursday while euro area construction data should be consistent with growth in the sector at the start of Q2.

Daily bond market movements

Bond	Yield	Change
BKO 1.7 06/27	1.836	-0.024
OBL 2.4 04/30	2.103	-0.036
DBR 2½ 02/35	2.497	-0.033
UKT 3¾ 03/27	3.886	-0.026
UKT 4⅜ 03/30	4.010	-0.038
UKT 4½ 03/35	4.500	-0.047

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

Euro area

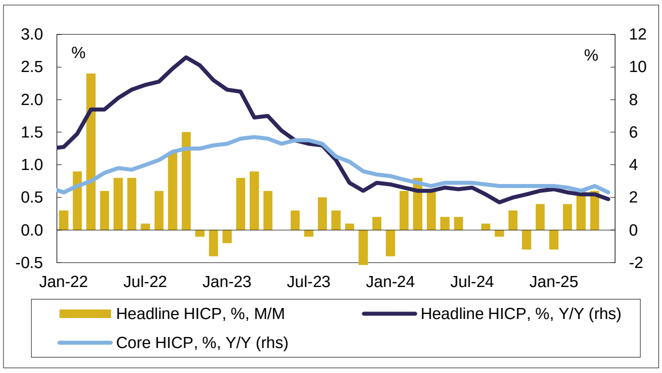
Sub-target inflation in May confirmed as detail confirms distortion caused by timing of Easter

While revisions had previously been made to some of the member states' preliminary May inflation data, those adjustments had broadly cancelled each other out. As a result, today's final estimates of euro area inflation for last month confirmed the flash figures. So, the headline HICP rate moderated in May by 0.3ppt – more than had originally been expected ahead of the preliminary release – to 1.9%Y/Y, the lowest since October and just the third sub-target reading since mid-2021. Likewise, there was a welcome moderation in core inflation, which fell a chunky 0.4ppt to 2.3%Y/Y, the lowest since January 2022. That drop reflected a notable stepdown in the all-important services component by a hefty 0.8ppt – the most in 20 months – to 3.2%Y/Y, the softest rate since April 2022, as the distortion caused by the timing of Easter on holiday-related prices passed. Indeed, inflation of airfares fell more than 16½ppts (to -2.8%Y/Y) while the components for package holidays (down more than 7½ppts to 1.9%Y/Y) and accommodation (down almost 2ppts to 3.2%Y/Y) also subtracted significantly. And, on a seasonally-adjusted basis, services prices in May fell by a record amount for the month. Meanwhile, core goods inflation remained low and stable at just 0.6%Y/Y for a fourth consecutive month. And the pickup in inflation of food, alcohol and tobacco was a touch smaller than suggested by the flash estimate, at 0.2ppt. That, however, pushed up that category to a 15-month high of 3.2%Y/Y reflecting continued pressures in prices of beef, chocolate and coffee.

Middle East impact on inflation measured, but final ECB rate cut in September now jeopardised

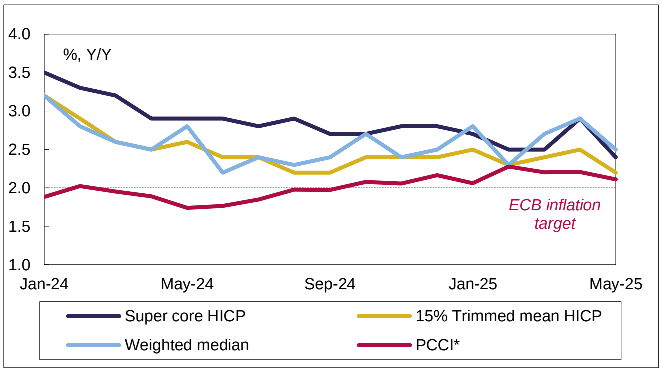
Like inflation of core goods, the energy component was also steady in May, albeit firmly in negative territory at -3.6%Y/Y. Given less favourable base effects, we always expected this to represent the trough for the year. And the rise in crude oil prices since Israel launched airstikes on Iran, as well as additional upside risks to such prices if the conflict significantly disrupts energy exports from the region, means that energy is bound to weigh less heavily on inflation during the second half of the year. Higher energy prices are also likely to add some upwards pressure to other inflation components, from air and other transport fares to prices of food and core goods. The rise of more than 10% in Brent crude oil prices above the ECB's assumption for the year ($66.7 per barrel) might be expected to add about 0.4ppt to inflation directly via the energy component over the near term and a further 0.2ppt to inflation indirectly if and when it is passed on to other items over a longer period. Admittedly, new downwards pressure on energy prices should arrive by the start of 2026 thanks to the German government's plans to cut electricity taxes and grid fees, abolish a gas levy and lower industrial power prices. And with moderating labour costs supporting the disinflation trend – reflected in an easing in the supercore and trimmed mean measures in May – we continue to expect headline inflation to remain close to target through H225 and 2026, as long as the worse-case scenarios in the Middle East are avoided. However, unless we see a significant weakening of economic activity and/or further meaningful appreciation of the euro over the near term, fears of new upside risks to inflation from energy

Euro area: Headline & core HICP inflation



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Selected measures of underlying inflation



**Persistent and common component of inflation.*
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

prices and their second-round effects might now deter a majority of Governing Council members from backing a final ECB rate cut this cycle in September.

The day ahead in the euro area

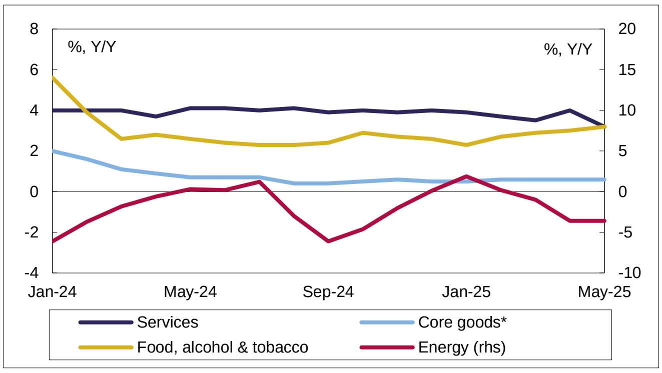
April's construction data will mark the sole economic data release for the euro area on Thursday. While still relatively subdued, business sentiment surveys have begun to show green shoots over recent months in response to the ECB's looser monetary policy stance and promises of greater public infrastructure investment in Germany. We expect April's construction reading to be strong, potentially with growth approaching 1%M/M. That would go towards offsetting some of February's weakness (-1.2%M/M), which restricted growth over Q1 to 0.1%3M/3M, and raise the likelihood of another quarterly increase in Q2. Indeed, while often-revised data from Italy are still forthcoming, output was reportedly higher in member states cumulatively contributing to just shy of 80% of the total euro area figure, with three-quarters of that share owing to increases in Germany (1.4%M/M), France (0.7%M/M) and Spain (4.3%M/M). Meanwhile, ECB President Lagarde will deliver a virtual keynote speech to a conference in Kyiv, jointly organised by the Polish and Ukrainian central banks.

UK

Headline CPI in line with BoE projection, core services inflation softest since January 2022

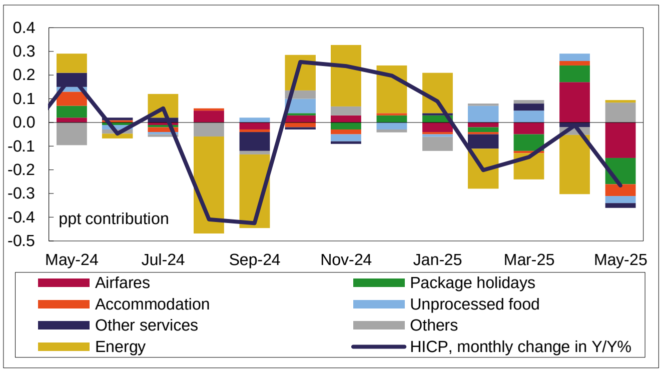
There were no major surprises in today's inflation figures. After jumping a steep 0.9ppt to a 15-month high in April, the headline CPI rate eased just 0.1ppt in May to 3.4%Y/Y, a touch above the Bloomberg survey consensus but nevertheless bang in line with the BoE's projection in its May Monetary Policy Report. Admittedly, the decline in large part reflected the correction to April's Vehicle Excise Duty (VED) discrepancy, which led a near-7%M/M drop in prices of 'other personal transport services' and knocked 0.12ppt off the headline CPI rate. There was also a normalisation of price-setting in certain travel-related components after the hikes over the Easter holiday period. For example, airfares fell 5%M/M after surging 27½%M/M in April to push the annual rate down 20ppts to -4.0%Y/Y. As such, overall services inflation fully reversed the 0.7ppt rise in the prior month to fall back in May to 4.7%Y/Y, bang in line with the BoE's forecast. Committee members should be encouraged to see ongoing disinflation in underlying services inflation too. Indeed, a measure of core services inflation watched by the BoE – which excludes volatile and indexed components – fell to the lowest level since January 2022 (4.1%Y/Y), some 3.4ppts below the peak in early 2023.

Euro area: Key HICP components



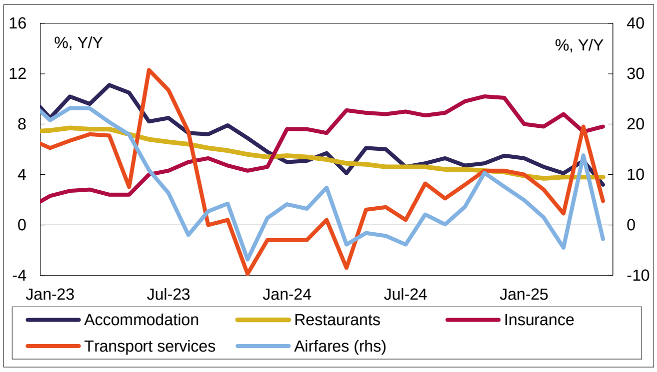
*Non-energy industrial goods.
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Monthly change in annual HICP inflation



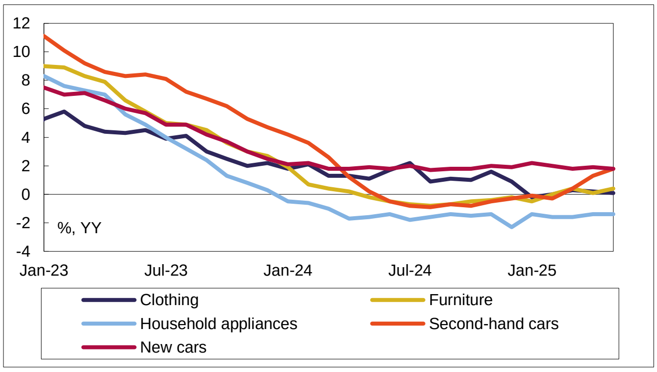
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Selected services HICP inflation



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Selected goods HICP components

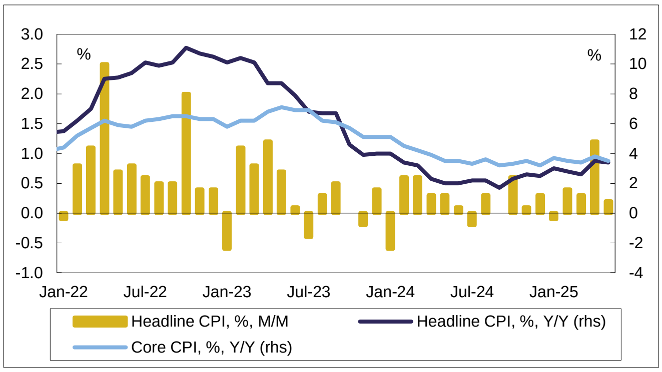


Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Core goods inflation ticks higher, while food inflation jumps to a 14-month high

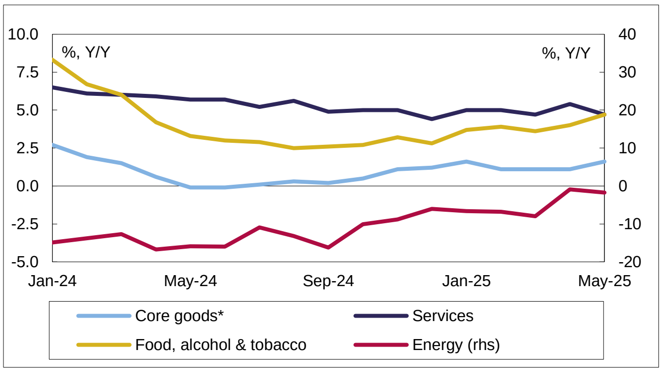
Despite the softening of services price pressures, core inflation only partly reversed the increase in April, falling ‘just’ 0.3ppt to 3.5%Y/Y. An above-average increase in prices of non-energy industrial goods pushed the annual core goods rate up to a four-month high (1.6%Y/Y) and double the average of the past 12 months. An uptrend was evident in a range of goods, including furniture and new and second-hand cars. And while still absent of any meaningful pressure, inflation of household appliances (0%Y/Y) jumped almost 4½ppts on the month. Within the non-core components, a further drop in petrol prices pushed energy inflation lower (-1.7%Y/Y) albeit still leaving it a chunky 6.3ppts above the March level. And the more hawkish members of the MPC might be concerned about potential second-round effects emanating to food, alcohol and tobacco inflation, which rose 0.7ppt to 4.7%Y/Y, a 14-month high and 1.2ppts above the BoE’s projection, due to double-digit inflation of chocolate, beef, butter and coffee – pressures that were also seen in the euro area data.

UK: Headline & core CPI inflation



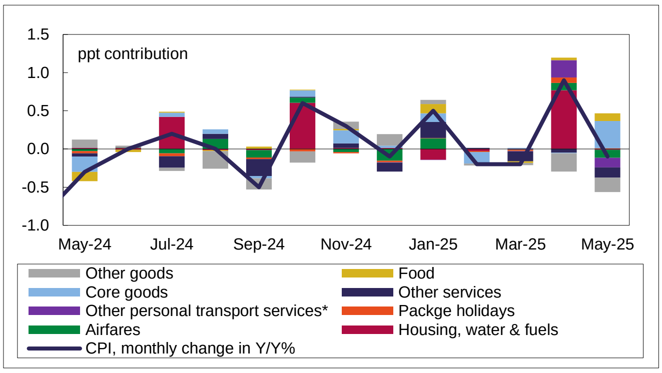
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Key CPI components



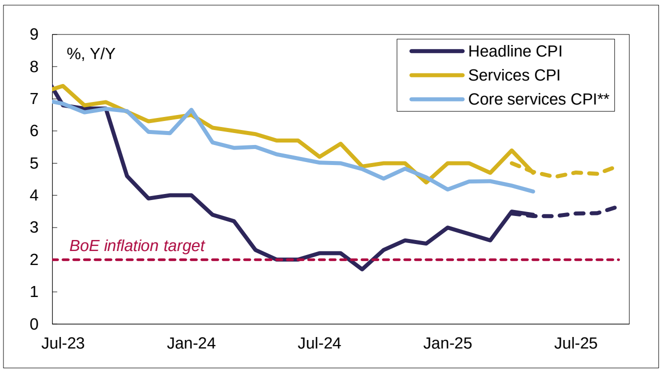
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Monthly change in annual CPI inflation



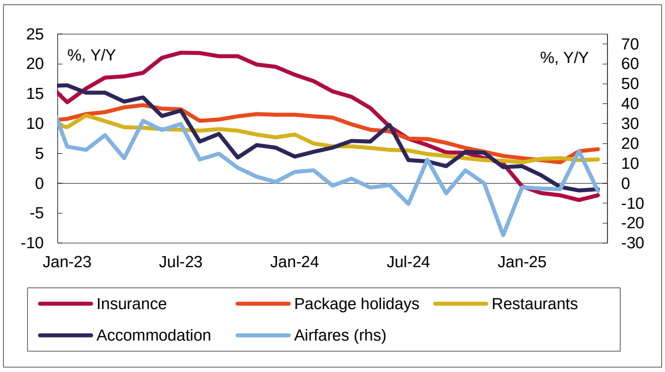
**Including Vehicle Excise Duty.*
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Headline & services inflation*



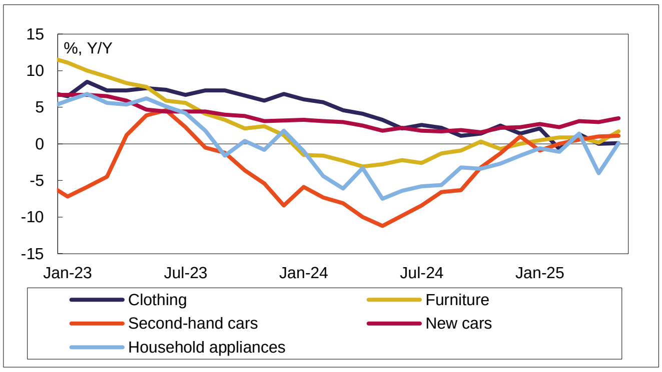
**Dashed lines are BoE projection from May-25 MPR. **Services excluding indexed and volatile components, rents and foreign holidays.*
Source: Macrobond, BoE and Daiwa Capital Markets Europe Ltd.

UK: Selected services inflation components



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

UK: Selected goods inflation components



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

Inflation peak unlikely to come before the autumn, but next rate cut still on track for August

Perhaps even more than in the euro area, the UK's inflation outlook remains highly uncertain. Despite the near-7% cut in the regulated household energy price cap to come in July, the energy component is likely to rise steadily through to September due to less favourable base effects as well as the pickup in oil and gas prices related to the Israel-Iran conflict. And the energy price cap now seems likely to rise back again in October. While food inflation might be at or near the peak, it is also likely to add around ¾ppt to headline inflation over the next six months or so. We forecast services inflation to move broadly sideways at around 4½%Y/Y over coming months too. And notwithstanding the potential dampening impact of recent sterling appreciation, core goods inflation will also be boosted by unfavourable base effects. So, like the BoE's May projection, we expect headline inflation to peak in September above 3½%Y/Y, and the decline thereafter might be relatively gentle. Even before the Israeli strikes on Iran, the BoE's MPC was bound to keep Bank Rate steady tomorrow (see below). And the hawks on the Committee might now also be wary of supporting a rate cut until the peak in inflation is firmly in the rear-view mirror. Nevertheless, we think the ongoing softening of the labour market and clear moderation of private regular pay growth will still encourage the majority of MPC members to back a cut in August, and further easing before year-end.

The day ahead in the UK

Thursday's monetary policy announcement will see the MPC hold Bank Rate at a steady 4.25%. Unlike last month's finely balanced three-way split, when policy was eased by 25bps, we expect a relatively more comfortable seven-to-two majority on the MPC in support of the status quo, with external members Dhingra and Taylor the dissenters backing a further 25bps cut. We also expect the MPC to leave intact its forward guidance – that 'a gradual and careful approach to the further withdrawal of monetary policy restraint remains appropriate' – which we interpret to be consistent with one 25bps per quarter into next year. Indeed, while the MPC revised down its GDP growth and inflation projections at May's meeting, it still expected headline inflation to rise over the near term, peaking at 3.7%Y/Y in September. That should reinforce the reluctance of a majority to accelerate the frequency of rate cuts for the time being, or at the very least until their projections are next revised in August, with many on the Committee attaching significant weight to concerns about potential second-round effects and their spillovers into inflation expectations. Recent data also suggest that their latest projections remain broadly intact, with today's headline inflation print (3.4%Y/Y) matching the BoE's projection for a second month (retrospectively correcting April's Vehicle Excise Duty numbers). Services inflation (4.7%Y/Y) too aligned with the Bank's estimates for May. And while last week's activity and labour market data were softer than expected, with private sector pay growth continuing to undershoot the Bank's projections, we expect the majority to refrain from placing excessive weight on just one month's figures, which are susceptible to their own shortcomings and data quality challenges. The MPC will also remain alert to the recent increase in gas and oil prices, with the latter currently up more than 20% since the 8 May policy meeting and futures contracts around $6/bbl higher in 2026 relative to the BoE's conditioning assumption. So, policymakers will certainly want to see another cycle of data over the summer, with hopes to receive greater clarity on global trading relationships and events in the Middle East ahead of August's decision.

European calendar

Today's results							
Economic data							
Country		Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Euro Area		Final headline (core) HICP Y/Y%	May	**1.9 (2.3)**	*1.9 (2.3)*	2.2 (2.7)	-
UK		CPI (core CPI) Y/Y%	May	**3.4 (3.5)**	*3.3 (3.5)*	3.5 (3.8)	-
		House price index Y/Y%	Apr	**3.5**	-	6.4	7.0
Auctions							
Country		Auction					
Germany		sold €988m of 2.5% 2046 bonds at an average yield of 2.92%					
		sold €1.408bn of 2.5% 2054 bonds at an average yield of 2.99%					

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	Construction output M/M% (Y/Y%)	Apr	-	0.1 (-1.1)
UK		12.00	BoE Bank Rate %	Jun	*4.25*	4.25
Auctions and events						
Euro Area		08.30	ECB President Lagarde to deliver virtual keynote at NBU/NBP research conference, Kyiv			
France		09.50	Auction: to sell up to €12bn of 2.4% 2028, 2.75% 2030 & 2.7% 2031 bonds			
		10.50	Auction: to sell up to €1.75bn of 0.1% 2028, 0.6% 2034 & 0.1% 2038 inflation-linked bonds			
Spain		09.30	Auction: to sell 1.95% 2030, 3.15% 2033 & 3.2% 2035 bonds			
UK		12.00	BoE monetary policy announcement and minutes to be published			
		12.00	BoE to publish quarterly Agents' summary of business conditions (Q225)			

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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