

Euro wrap-up

Overview

- While the ECB raised rates for the first time since 2023 and signalled the likelihood of additional tightening to come, Bunds followed USTs higher.
- Gilts also made modest gains while a UK survey flagged expectations of near-term house price declines but stability 12 months ahead.
- Friday will bring UK GDP data for April, along with final inflation estimates for May from Germany, France and Spain.

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Daily bond market movements

| Bond | Yield | Change |
|---------------|-------|--------|
| BKO 2½ 06/28 | 2.672 | -0.039 |
| OBL 2½ 04/31 | 2.756 | -0.042 |
| DBR 2.9 02/36 | 3.030 | -0.043 |
| UKT 4¾ 03/28 | 4.336 | -0.025 |
| UKT 4¾ 03/31 | 4.462 | -0.027 |
| UKT 4¾ 10/35 | 4.904 | -0.026 |

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

Euro area

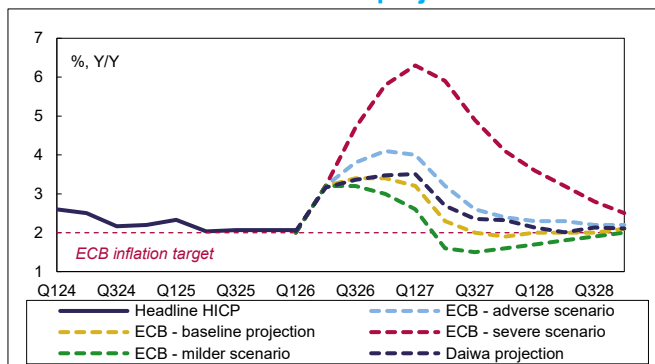
ECB hikes & signals likelihood of additional tightening to come

As Governing Council members had increasingly signalled over recent weeks, the ECB today raised rates for the first time since 2023 in a unanimous decision with no alternative policy option considered. The 25bp hike took the deposit rate to 2.25%, a level that hardly appears particularly restrictive. Indeed, Lagarde noted that the tightening was “not forceful”. And while the Governing Council insisted that future rate decisions will remain data dependent and taken on a meeting-by-meeting basis with no pre-set path, the implication of the policy statement, press conference and projections is that the ECB’s policy rates have further to rise. Lagarde repeatedly criticised earlier suggestions by commentators (including Finnish Governor Rehn) that today’s decision might be considered an insurance hike. She emphasised that the energy shock has now endured longer than originally envisaged, with direct and indirect impacts on inflation already evident. So, while it was too soon to see any evidence of second-round effects via wages, she made clear that the case for today’s hike was ‘robust’ and justifiable under all of the scenarios projected by the ECB, including a new ‘milder’ one based on the assumption that energy prices fall significantly below the current futures curves. Indeed, even assuming that the deposit rate averages 2.75% next year – implying one more rate hike than was factored into the ECB’s March projections – the ECB’s inflation outlook was revised up this year and next. As such, two further hikes – with the next one perhaps coming as soon as July – might now be most likely, even if there is a near-term resolution to the stalemate at the Strait of Hormuz.

Core inflation to remain above-target in 2028, even under the ECB’s new ‘milder’ scenario

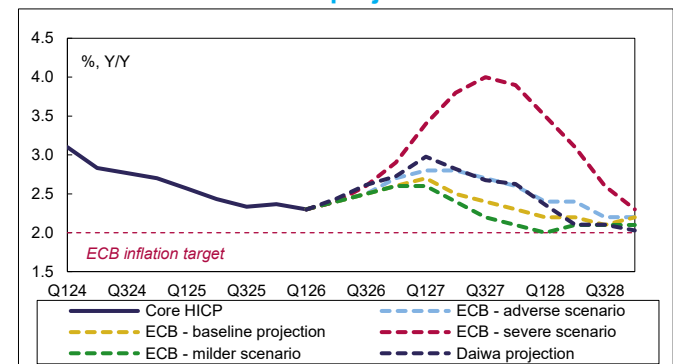
Under the ECB’s baseline projection, which incorporates recent swap rate and energy price curves, the outlook for HICP inflation was revised up by 0.4ppt this year and 0.3ppt next to 3.0%Y/Y and 2.3%Y/Y respectively. Given the assumption of falling energy prices over coming quarters, the headline rate is then projected to drop to the 2.0%Y/Y target in 2028. But reflecting the expectation of some second-round effects via wages, the baseline core inflation outlook was revised up over the horizon to remain above-target at 2.2%Y/Y at the end of 2028. And it would be expected to be higher still under the ECB’s adverse and severe scenarios, which both assume a stronger and more persistent energy price shock and, in the latter, stronger indirect and second-round effects. That would point to upside risks to current market pricing of ECB rates. Moreover, even under the milder scenario, whereby the crude oil price drops to \$88 per barrel and gas prices to €41 per MWh in Q3 and then remains about 15-20% below the baseline curve over the horizon, core inflation is expected to average 2.1%Y/Y in 2028, underscoring the case for additional monetary tightening this year even in the event of a near-term resolution to the Middle East conflict and resumption of freight transit via the Strait of Hormuz.

Euro area: Headline inflation projections



Source: ECB Jun-26, Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Core inflation projections

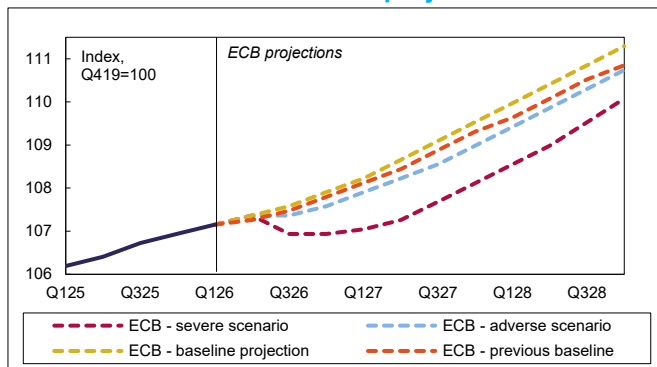


Source: ECB Jun-26, Macrobond and Daiwa Capital Markets Europe Ltd.

GDP expected to remain resilient, underscoring importance of inflation outlook in driving policy

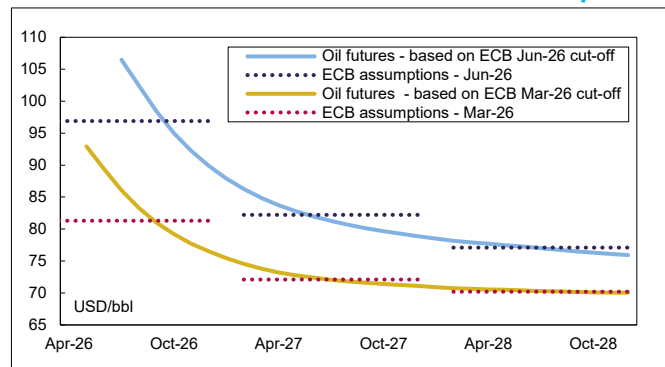
One reason for the expectation of some persistence in core inflation without additional monetary tightening is the resilience of the labour market and economic activity. Indeed, the euro area unemployment rate is expected to remain close to the series low of 6.2% this year and next before falling to 6.0% in 2028. While real wages are expected to be falling in the second half of this year, they are forecast to pick up again from early 2027. And so, household consumption is expected to continue to grow and make the largest contribution to GDP growth over the horizon. Public investment in defence and infrastructure should also continue to boost economic activity. So, while business investment is expected to soften over the near term in response to the shocks from the Middle East, and net trade is expected to weigh this year, the baseline projection for euro area GDP growth (excluding the distortion of Ireland) was revised down by just 0.1ppt this year and next to 0.8%Y/Y and 1.2%Y/Y, before an acceleration to 1.5%Y/Y in 2028. And even under the severe scenario, GDP is expected to contract only briefly in Q3 before stabilising in Q4 and returning to expansion from Q127 on. Certainly, while the risks to growth are inevitably skewed to the downside, the ECB will not be at all perturbed by that outlook. Instead, containing the deterioration of the inflation outlook will remain paramount. So, with risks to prices skewed to the upside, policy looks bound to be tightened further, with two-sided risks to current market pricing.

Euro area: GDP levels & ECB projections



Source: ECB Jun-26, Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Brent crude futures & ECB assumptions



Source: ECB, Bloomberg and Daiwa Capital Markets Europe Ltd.

The day ahead in the euro area

Final May inflation estimates from Germany, France and Spain will be the euro area data focus on Friday. In addition to flagging the possibility of revisions in next Wednesday's final euro area figures, the granular details should shed light on the drivers of the services-led uptick in inflation reported in the flash figures. We expect a fair amount of that pressure to have stemmed from rebounds in more volatile categories like package holidays and airfares, which were subdued in April by calendar distortions and are also vulnerable to cost pressures associated with the oil shock. Energy inflation, on the other hand, was seen broadly stable, albeit a key factor explaining the variability across the member states. In particular, the temporary tax cut on fuels in Germany is likely to explain the surprising 0.2ppt drop in that country's HICP inflation rate (to 2.7%Y/Y) in May, while energy led the acceleration in France (2.8%Y/Y). The inflation detail will also show whether, as we suspect, softer food inflation was related primarily to fading pressures in those categories, such as chocolate, fruit and meat, that were subject to particular strength last year.

UK

Survey flags expectations of near-term home price declines but stability 12 months ahead

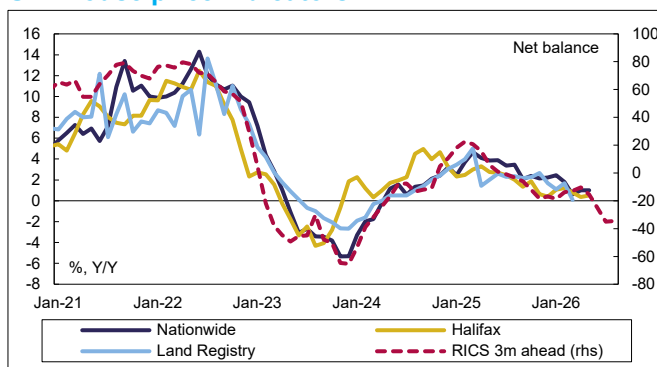
UK house prices have slowed significantly over recent months. The weakening in the official registration-based home price growth rate in March to zero percent was exaggerated by a base effect associated with the jump in prices ahead of changes to Stamp Duty a year earlier. But the timelier mortgage approval-based data from Nationwide and Halifax also pointed to weak house price growth in May at 1.7%Y/Y and 0.5%Y/Y respectively. And with rates on new mortgages having jumped roughly 100bps since the outbreak of the conflict, today's RICS residential survey results for May suggested that conditions in the market remain challenging, albeit with hints of stabilisation in the pace of softening. With new buyer enquiries still falling at a relatively firm pace (with a survey net balance of -34%) and agreed sales similarly down significantly (-37%), house prices were judged to have fallen too. Indeed, the respective survey index (-35% for a second successive month) matched the weakest in 2½ years, with price declines most significant in London, the Southeast and East Anglia. The RICS balance of house price expectations three months ahead (-45%) – which has strong leading indicator properties – suggested that price declines are expected to be the most widespread since August 2023 when Bank Rate was last hiked by the BoE. But near-term sales expectations were not quite so negative as in the prior month. And over a 12-month horizon, sales expectations were broadly neutral while price expectations (+6%) were consistent with our expectation of very modest growth. In the rental sector, however, tenant demand reportedly picked up. And with rental instructions in reverse due not least to regulatory and tax changes, rent expectations increased, with the respective index (+36%) the strongest in a year.

The day ahead in the UK

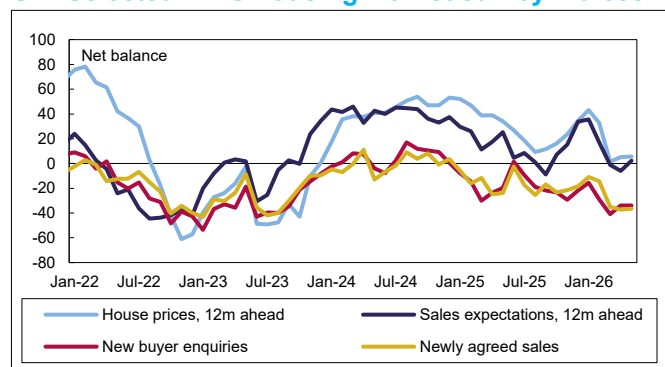
While it has been a relatively quiet few days for the UK dataflow, it will be a busy end to the week. April's monthly GDP report should garner most headlines. Economic activity surprised to the upside for a second successive month in March, with growth of 0.3%M/M reinforcing a solid outturn of 0.6%Q/Q in Q1. We would caveat, however, that March's resilience appeared to have been boosted in part by the efforts of households and businesses to shield themselves from the latest oil shock. Indeed, the PMIs flagged a further acceleration in growth momentum at the start of Q2, which might be indicative of upside risks to production from stockpiling efforts in April. But fuel sales certainly won't offer much support. Indeed, retail sales volumes fell back sharply in April (-1.3%M/M), more than fully reversing their gains in March, as households cut back buying petrol. Core sales were also weaker, highlighting downside risks to consumer-facing services. And the potential fading of Easter-related base effects raises further downside risks. For industry, support related to the normalisation in autos production at JLR now looks close to being exhausted. And the pullback in the construction PMIs suggests that payback for the strength of that sector in Q1 (1.5%Q/Q) will be forthcoming. So, we expect GDP to slip back by 0.2%M/M at the start of Q2. That would still be consistent with solid growth on a rolling three-month basis (0.7%3M/3M), reflecting the strength of carry-over from recent months. But as the stagnation in the latest round of PMIs shows, the risks this quarter are skewed firmly to the downside. And we expect growth momentum to slow to a more modest pace – potentially just 0.1%3M/3M – by the end of the quarter.

The GDP data, however, are unlikely to be material to the votes of any MPC members at next week's monetary policy meeting, at which we expect the BoE to maintain an 'active hold' to Bank Rate. At least one more member – external MPC member Greene – will join Chief Economist Pill in calling for additional restrictiveness. But the vote split on the committee could yet be influenced by other data including tomorrow's update to the BoE's quarterly inflation attitudes survey. Indeed, the previous iteration of the survey showed moderation, reporting that household year-ahead inflation expectations had softened 0.3ppt in Q1 to a three-quarter low of 3.2%Y/Y. But that survey was conducted in mid-February, prior to the oil shock, and an increase this quarter looks inevitable. Given the sensitivity of some MPC members to similar bellwethers of second-round inflation effects, the magnitude of that increase could be of consequence to their votes, albeit surely not the MPC's final decision.

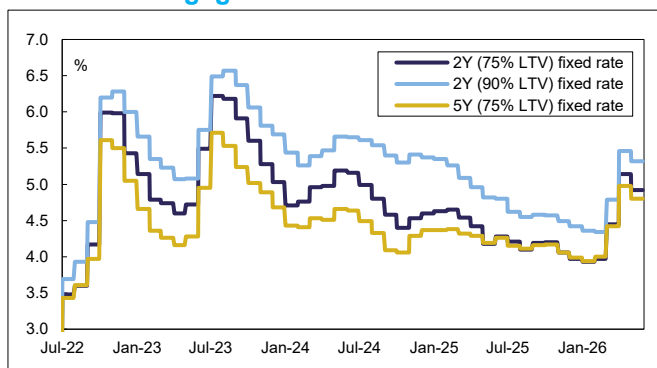
UK: House price indicators



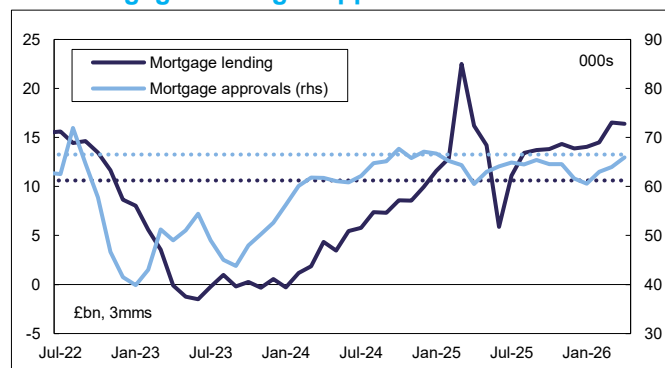
UK: Selected RICS housing market survey indices



UK: New mortgage interest rates





UK: Mortgage lending & approvals*





European calendar

Today's results

Economic data

| Country | Release | Period | Actual | Market consensus/ <i>Daiwa forecast</i> | Previous | Revised |
|-----------|--|--------|--------------------|--|-------------|---------|
| Euro area |  ECB Deposit (Refinancing) Rate % | May | 2.25 (2.40) | <u>2.25 (2.40)</u> | 2.00 (2.15) | - |
| UK |  RICS house price balance % | May | -35 | -32 | -34 | -35 |


Auctions

| Country | Auction |
|---------|--|
| Italy |  sold €4bn of 3% 2029 bonds at an average yield of 3.03% |
| UK |  sold £5bn of 4% 2029 bonds at an average yield of 4.419% |


Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Wednesday's results

Economic data

| Country | Release | Period | Actual | Market consensus/ <i>Daiwa forecast</i> | Previous | Revised |
|---------|---|--------|------------------|--|-----------|---------|
| Italy |  Industrial production M/M% (Y/Y%) | Apr | 0.5 (1.3) | 0.1 (0.5) | 0.7 (1.5) | - |





Auctions

| Country | Auction |
|---------|--|
| Germany |  sold €3.982bn of 2.9% 2036 bonds at an average yield of 3.06% |



Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

| Country | BST | Release | Period | Market consensus/ <i>Daiwa forecast</i> | Previous | |
|---------|---|-----------------------|--|--|-------------------|--------------|
| Germany |  07.00 | Final HICP (CPI) Y/Y% | May | <u>2.7 (2.6)</u> | 2.9 (2.9) | |
| France |  07.45 | Final HICP (CPI) Y/Y% | May | <u>2.8 (2.4)</u> | 2.5 (2.2) | |
| Spain |  08.00 | Final HICP (CPI) Y/Y% | May | <u>3.6 (3.2)</u> | 3.5 (3.2) | |
| UK |  | 07.00 | Monthly GDP M/M% (3M/3M%) | Apr | <u>-0.2 (0.7)</u> | 0.3 (0.5) |
| | | 07.00 | Services output M/M% (3M/3M%) | Apr | -0.1 (0.8) | 0.3 (0.8) |
| | | 07.00 | Industrial output M/M% (Y/Y%) | Apr | 0.1 (-0.1) | -0.2 (0.0) |
| | | 07.00 | Construction output M/M% (Y/Y%) | Apr | -0.7 (-1.7) | 1.5 (-0.3) |
| | | 07.00 | Trade (goods trade) balance £bn | May | -5.4 (-21.0) | -9.7 (-27.2) |
| | | 09.30 | BoE/Ipsos inflation attitudes survey – 1Y ahead CPI Y/Y% | Q2 | - | 3.2 |

Auctions and events

| | | | |
|---------|---|-------|--|
| Germany |  | - | Bundesbank to publish updated economic forecasts for Germany |
| UK |  | 09.30 | BoE to publish quarterly Agents' summary of business conditions for Q226 |

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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