

Euro wrap-up

Overview

- Bunds followed the global trend higher as global energy prices fell further, while a German survey flagged an uptick in investor optimism.
- Having also made gains on Monday, Gilts ended today little changed.
- Wednesday will bring May inflation data from the UK and euro area.

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Daily bond market movements

Bond	Yield	Change
BKO 2½ 06/28	2.561	-0.007
OBL 2½ 04/31	2.645	-0.018
DBR 2.9 02/36	2.928	-0.025
UKT 4¾ 03/28	4.179	+0.011
UKT 4¾ 03/31	4.323	±0.000
UKT 4¾ 10/35	4.788	-0.023

*Change from close as at 5:00pm BST.

Source: Bloomberg

Euro area

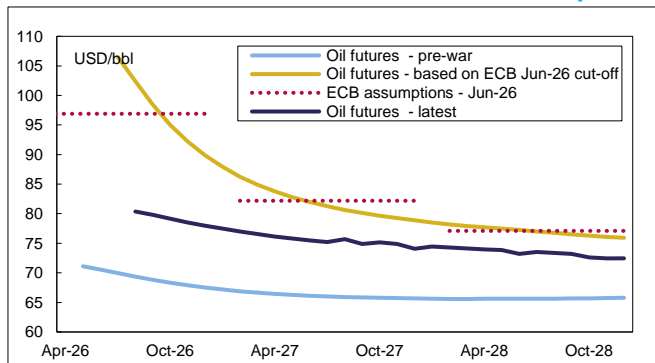
Despite high uncertainty, US-Iran deal points towards the ECB's more optimistic scenarios

European market moves at the start of the week have inevitably been driven by Sunday's news that a US-Iran memorandum of understanding has been tentatively agreed. But European policymakers won't be quite so hasty to discard their cautious response to the conflict and will still be wary that their most 'severe' projection scenarios might yet play out. Even if a deal is signed on Friday, uncertainty will remain high with clear implementation risks during the protracted negotiation period. And with inflation already elevated and supply disruptions still feeding through the economy, swap markets rightly continue to price the likelihood of further ECB tightening this year. But some form of détente suggests that baseline forecasts should assume a more moderate path for energy prices. Spot Brent crude and natural gas prices have fallen at least 15% since the Governing Council's policy announcement last week to hover between the assumptions used in the ECB's baseline and 'milder' scenarios. If sustained, downwards pressure on prices could mitigate the propagation of indirect and second-round inflation effects, while consumption and investment should support GDP growth. To some extent, the prospect of such an improvement was reflected in today's June German ZEW survey. The survey period – from 8-15 June – bisected both the ECB's decision and reports of de-escalation in the Middle East, which perhaps dulled their optimism. Still, the economic expectations balance (+10.5%) returned to positive territory for the first month in four. And profit expectations broadly improved, and most markedly in the previously downbeat autos and chemicals sectors. The exception to that trend was construction, which is likely to be a function of bets of further ECB rate hikes over coming months. Indeed, we note that investor perceptions of banks – another rate-sensitive sector – were also slightly more upbeat.

GDP unlikely to contract, but will remain subdued into Q3

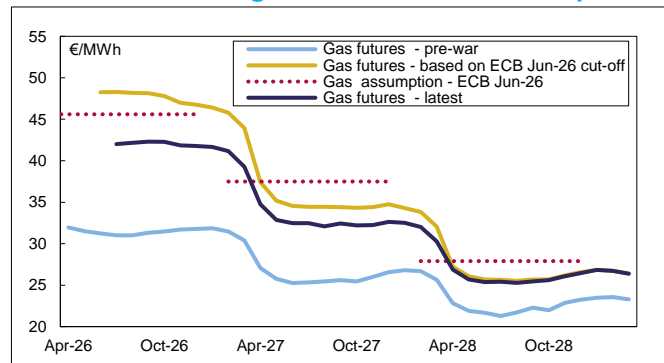
On the other hand, the ZEW survey also suggested that respondents have become increasingly downbeat about the current economic situation. More than four fifths of respondents – the most since December – judged that current conditions are 'bad'. While a US-Iran deal clearly diminishes some of the near-term downside risks to GDP growth, and hence the likelihood of another quarterly contraction in Q3 (barring any more exceptional distortions from Ireland), business surveys such as the PMIs have already flagged a notable deterioration in growth momentum towards the end of Q2. And underlying growth is likely to remain soft at least into Q3 as household real incomes are squeezed and confidence amongst firms and households alike recovers only tentatively. The PMIs suggest that weakness has been most pronounced in the services sector. But, as President Lagarde noted in her post-meeting remarks last week, manufacturing output has 'held up so far', reflecting firms' stockpiling efforts as well as higher spending on defence.

Euro area: Brent crude futures & ECB assumption



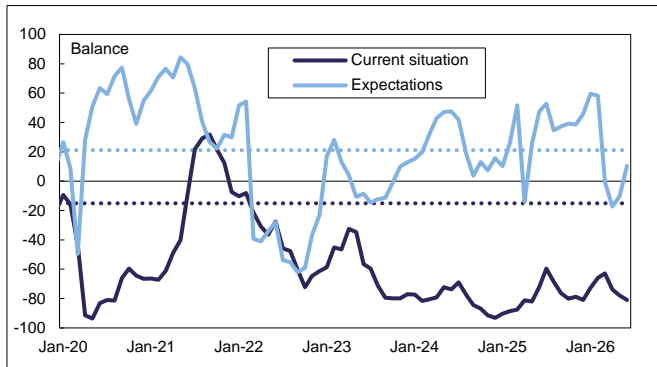
Source: Bloomberg, ECB and Daiwa Capital Markets Europe Ltd.

Euro area: Natural gas futures & ECB assumption



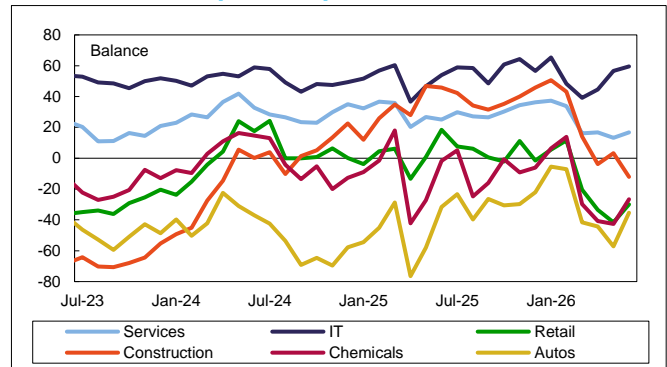
Source: Bloomberg, ECB and Daiwa Capital Markets Europe Ltd.

Euro area: ZEW economic conditions indices*



*Dotted lines show long-run averages.
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: ZEW profit expectations indices

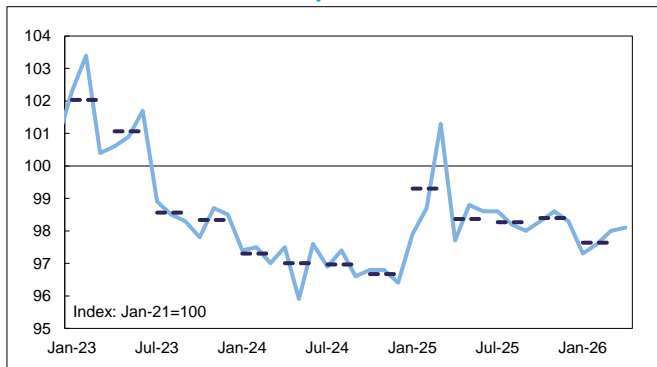


Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Manufacturers likely supporting growth in Q2 on stockpiling and defence orders

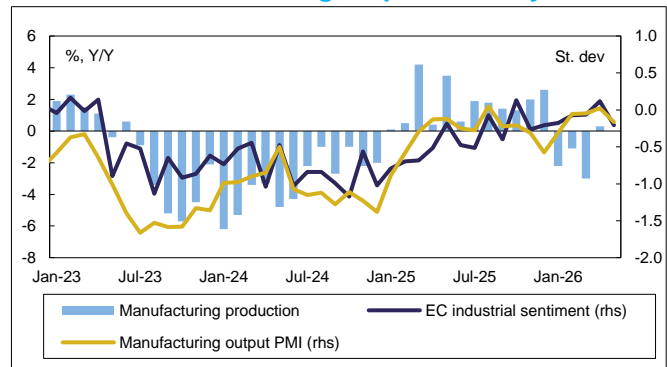
Investments in defence equipment is likely to offer support to industrial production over the horizon as governments gradually ramp up spending. And related subsectors remained especially visible in aspects of April's IP release. While little changed on the month, output of ammunition and explosives still up more than 10%Y/Y. And production of military vehicles rose 6.3%M/M to be up 67%Y/Y. Alongside growth in other related subsectors – including shipbuilding (6%M/M), rail (2%M/M) and aerospace (3.3%M/M) – output of other transport goods rose for a fourth consecutive month to be trending some 4½% above their Q1 level. Other subsectors, including electrical machinery (1.5%M/M), general machinery (1%M/M) and chemicals (2.2%M/M), were also stronger. And perhaps substituting for the loss of supply from the Middle East, petroleum refining activity also expanded for a third consecutive month, rising to levels last seen in early 2019. Admittedly, that strength in production was offset somewhat by weakness in the considerably larger autos sector (-3.1%M/M). And underwhelming payback from pharmaceuticals suggests that subsector will also struggle to avoid weighing on IP this quarter. Of course, both autos and chemicals remain exposed to the challenges posed by US tariffs and Chinese industrial policy. Meanwhile, with electricity production also down for a third straight month, overall IP expanded in April by just 0.1%M/M, its slowest rate since January. But that still left it ½% above its level in Q1, pointing towards a return to growth in Q2. And if supply-chain and cost pressures gradually fade in the event of a peace deal, notwithstanding the risks of some payback for recent stockpiling, the manufacturing sector should offer support to output in the second half of the year too.

Euro area: Industrial output*



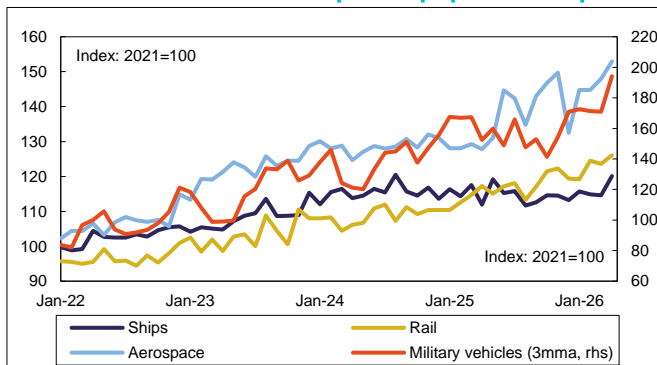
*Dashed dark blue lines represent quarterly averages.
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Manufacturing output & survey indices



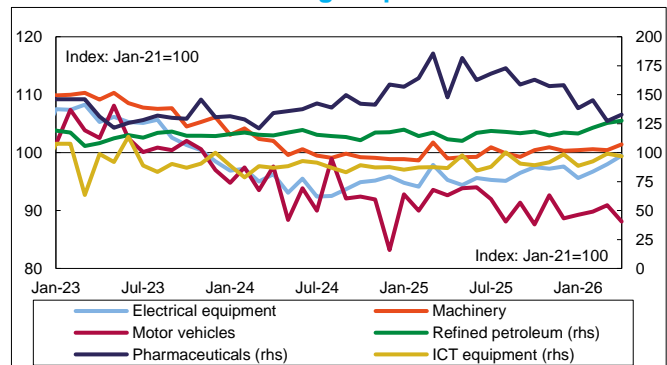
Source: Macrobond, S&P Global, EC and Daiwa Capital Markets Europe Ltd.

Euro area: Non-auto transport equipment output



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Manufacturing output in selected sectors

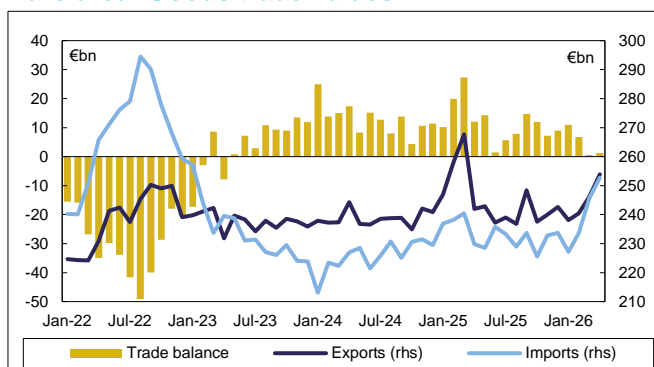


Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Trade surplus improves slightly in April but remains second smallest in almost three years

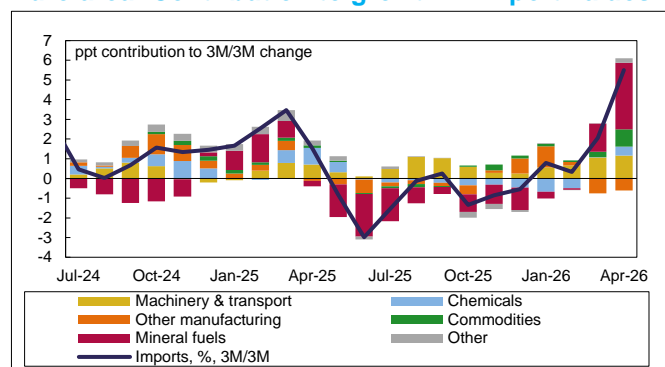
As a net energy importer, a gradual moderation in oil and gas prices should benefit the euro area's goods trade balance too. On a seasonally adjusted basis, the goods trade surplus amounted to just €1.3bn in April, the second smallest in almost three years outside of a downwardly revised March (€0.6bn). The value of imports continued to pick up firmly (2.9%*M/M*, 9.3%*Y/Y*), and for a third consecutive month, reflecting the higher cost of mineral fuels as well as higher volumes of other raw inputs and intermediate goods. But export values (3.2%*M/M*) rose slightly further which, at the margin, was helped by a recovery in exports to OPEC states (28.2%*M/M*). On balance, however, higher oil prices unsurprisingly meant that the bilateral trade surplus with that region remained in deficit. And crude oil and LNG supply from the US, at higher prices, also contributed to a narrower surplus with the euro area's largest trading partner. Exports to the US were little changed on the month. But owing to the imposition of 'Liberation Day' tariffs one year ago, and given the boost from the frontloading of shipments which preceded it, exports to the US were still down almost 30%*3M/Y*. Today's news that EU lawmakers had finally ratified the region's trade agreement with the US means that the risk of new trade barriers should have diminished, at least for now. But the challenges posed by the remaining tariffs, in addition to structural headwinds such as the competitive threat from Chinese autos, should continue to cloud the outlook for exports. So, notwithstanding the improved terms of trade from lower oil prices, we expect the contribution to GDP growth from net trade to be no better than broadly neutral over coming quarters.

Euro area: Goods trade values



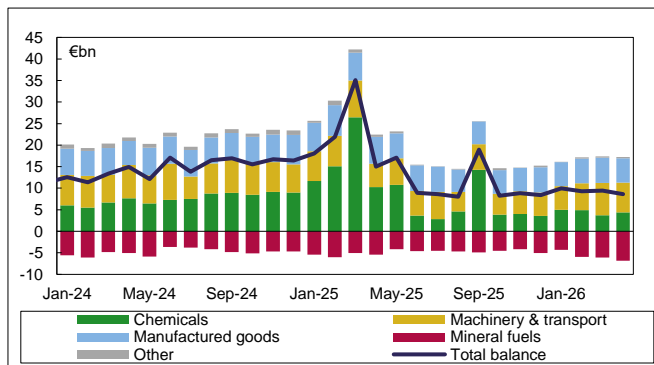
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Contribution to growth in import values



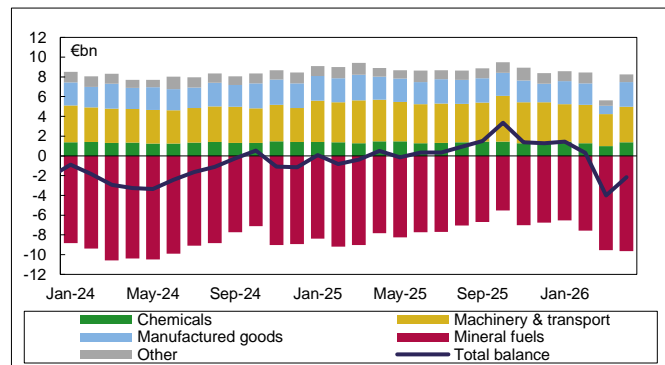
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Goods trade balance with the US



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Goods trade balance with OPEC



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

The day ahead in the euro area

Price data will be the focus for European markets on Wednesday, with May's final inflation estimates taking the spotlight in the euro area. Today's final inflation data from Italy were nudged down from the flash figures, reporting a more modest ½ppt increase in the HICP rate to 3.2%*Y/Y*. But the final numbers from the other large member states matched their preliminary readings. So, May's final euro area HICP figures should validate their flash estimates too. They suggested that headline inflation picked up again in May to 3.2%*Y/Y*, a 32-month high. But owing not least to the temporary German tax cut, energy prices in aggregate were broadly stable. And the final detail from the member states affirms that food inflation was softer. In contrast, the flash release showed core inflation rising at a 13-month high of 2.5%*Y/Y*. And given the fine margins involved (2.55% to 2 decimal places), we cannot discount the possibility of an upwards revision. The national data attributed the vast majority of that rise in inflation to a rebound in transport services and package holidays, reflecting the distortion of the timing of Easter. But evidence of second-round effects should be absent. And as the ECB's wage tracker update should provide further reassurance tomorrow by continuing to signal that wage settlement growth is gravitating towards a target-consistent range of 2½-2¾%*Y/Y* by year-end.





The day ahead in the UK

Like the euro area, May's inflation report will also be the highlight of the UK dataflow. We expect both the headline and core CPI rates to tick up by 0.3ppt, to 3.1%Y/Y and 2.8%Y/Y respectively, slightly above the Bloomberg consensus forecast. Further mirroring the euro area, we expect the upwards impetus to be provided by services as airfares and package holiday components receive payback for their weakness in April. Those components, and transport services more broadly, will also be vulnerable to indirect spillovers from oil prices, posing an extra upside risk. One expected point of difference will be for a steeper rise in 'other transport services'. Indeed, as a direct consequence of base effects relating to last year's [vehicle excise duty](#) error, that subcomponent might add as much as 0.1ppt to headline inflation. Still, as most of April's drop in inflation owed to the sharp drop in regulated household energy tariffs, that rise should only take CPI inflation halfway back to where it was in March. And non-core components should be better behaved too. Slightly lower auto fuel prices should have helped to keep energy inflation broadly stable below 7½%Y/Y. And we see a possibility of further moderation in food inflation too.



European calendar

Today's results

Economic data

Country	Release	Period	Actual	Market consensus/ <i>Daiwa forecast</i>	Previous	Revised
Euro area	 Final labour costs Y/Y%	Q1	3.2	<u>3.4</u>	3.4	-
	 Final job vacancy rate %	Q1	2.3	<u>2.2</u>	2.3	2.2
Germany	 ZEW current situation (expectations) balance	Jun	-81.0 (10.5)	-78.0 (-5.3)	-77.8 (-10.2)	-
Italy	 Final HICP (CPI) Y/Y%	May	3.2 (3.2)	<u>3.3 (3.2)</u>	2.8 (2.7)	-





Auctions

Country	Auction
Germany	 sold €3.824bn of 2.5% 2031 bonds at an average yield of 2.64%
UK	 sold £4.25bn of 4.875% 2036 bonds at an average yield of 4.858%

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	 Industrial production M/M% (Y/Y%)	Apr	0.1 (0.3)	<u>0.1 (0.4)</u>	0.2 (-2.1)	0.4 (-2.8)
	 Trade balance €bn	Apr	1.3	-	3.5	0.6
Germany	 Wholesale prices M/M% (Y/Y%)	May	-0.6 (5.9)	-	2.0 (6.3)	-
UK	 Rightmove house prices M/M% (Y/Y%)	Jun	-0.6 (-0.5)	-	1.2 (-0.3)	-





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	 10.00	Final headline (core) HICP Y/Y%	May	<u>3.2 (2.5)</u>	3.0 (2.2)
UK	 07.00	Headline (core) CPI Y/Y%	May	<u>3.1 (2.8)</u>	2.8 (2.5)
	 07.00	PPI – output (input) prices Y/Y%	May	4.0 (8.8)	4.0 (7.7)
	 09.30	House price index Y/Y%	Apr	-	0.0

Auctions and events

Euro area	 09.00	ECB to publish wage tracker update
Germany	 10.30	Auction: to sell up to €1bn of 3.4% 2047 bonds
	 10.30	Auction: to sell up to €1.5bn of 1.8% 2053 bonds

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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