Euro wrap-up

Overview

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- Shorter dated Bunds followed USTs lower, while euro area core inflation was nudged slightly higher.
- Shorter dated Gilts made gains following a downside surprise to UK inflation.
- On Thursday, the BoE is expected to leave Bank Rate unchanged at 3.75%, with some MPC members likely to flag that the inflation outlook is aligning more closely with its best-case scenario. UK labour market data are also scheduled.

Daily bond market movements

Bond	Yield	Change
BKO 2½ 06/28	2.582	+0.021
OBL 2½ 04/31	2.655	+0.010
DBR 2.9 02/36	2.926	-0.002
UKT 4⅜ 03/28	4.139	-0.040
UKT 4⅛ 03/31	4.284	-0.039
UKT 4¾ 10/35	4.750	-0.037

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

Euro area

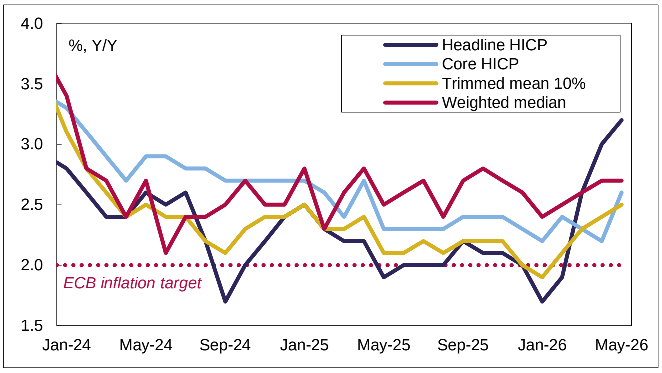
Core inflation revised up to 2.6%Y/Y but minimal evidence of indirect effects from oil price shock

The final estimate of euro area headline inflation in May aligned with the flash figure, confirming an increase of 0.2ppt to 3.2%Y/Y, the highest since September 2023. To one decimal place, the core rate was revised up slightly to a 13-month high of 2.6%Y/Y, representing an increase of 0.4ppt on the month. Given the rounding of the flash estimate, that was no surprise. Indeed, to two decimal places, the core rate was revised up by just 0.01ppt. As previously suggested, services inflation rose 0.5ppt to 3.5%Y/Y, matching the highest level since February 2025 and somewhat stronger than the initial consensus forecast. As suspected, that increase was fully accounted for by the reversal of the Easter-related calendar effect which had temporarily supressed inflation of package holidays, accommodation and transport services, particularly airfares, in April. Meanwhile, slowing inflation of certain other services offset the impact of higher mobile phone, web, cloud and other ICT service charges. And more expensive ICT equipment explained the further 0.1ppt pickup in core goods inflation to a two-year high of 0.9%Y/Y. So, there were no signs of significant indirect effects from the oil price shock on core categories. The same was true of food inflation, which slowed 0.5ppt to 1.9%Y/Y, the lowest since July 2021, thanks to moderation in items such as meat and coffee that had globally seen upwards pressure over the past year. And thanks to the temporary German tax cut, energy inflation was steady in May at 10.8%Y/Y. Thanks in part to the contribution from renewables, electricity inflation remained negative (-0.8%Y/Y) but the gas component picked up to a 12-monh high (3.9%Y/Y) and inflation of auto fuels and lubricants (21.1%Y/Y) and heating oil (43.4%Y/Y) softened only slightly from very high levels.

Wage settlements moderating, so lower wholesale energy curves reduce urgency of ECB hikes

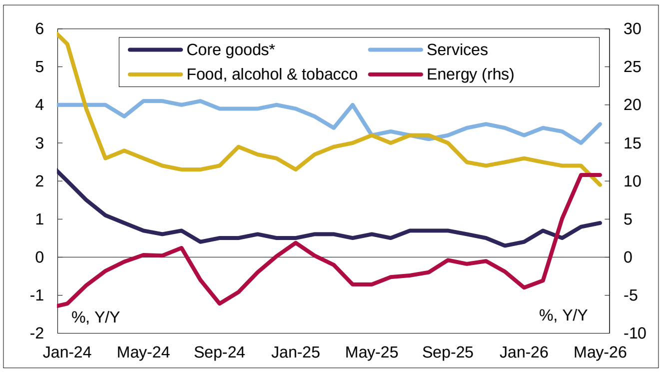
While there were few signs of indirect effects on core inflation in the May data, the Iran conflict has inevitably generated some pipeline pressures. Due to a double-digit rate in the energy component, euro area goods PPI inflation rose 3ppts in April to a three-year high of 4.9%Y/Y and likely rose again in May. But it will have remained a long way below the peak above 40%Y/Y in 2022. While petrol prices have fallen only a little more than 2% from their peak at the start of April, prices of diesel and heating oil are significantly more than 10% lower. Survey measures such as the input cost and output price PMIs edged up in May to the highest levels in more than three years. But we expect them to fall back in the flash June survey results, due Tuesday. Temporary fiscal measures to cushion the impact of higher energy prices will largely elapse at the end of this month. But the ECB's wage trackers today also reaffirmed that negotiated pay growth is on track to moderate by year-end to just 2.6%Y/Y, which would be consistent with achievement of the inflation target over the horizon, there remains no evidence of second-round effects via the labour market. And if sustained, the marked fall in wholesale oil and gas forwards over recent days to below the assumptions used in the ECB's projection scenarios will call for a significant downwards

Euro area: Headline & underlying inflation



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Key inflation components



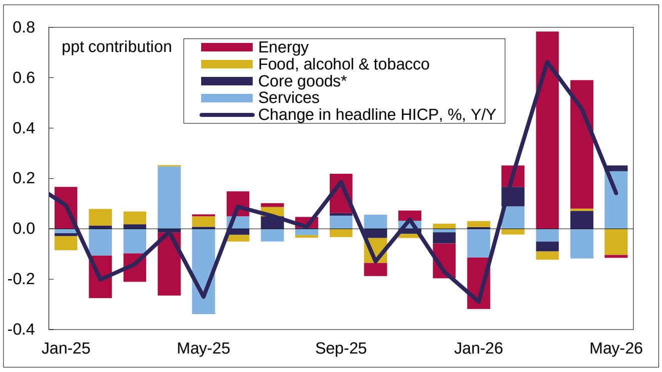
**Non-energy industrial goods.*
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

revision of the inflation outlook. Indeed, the headline inflation rate would likely peak no higher than 3½%Y/Y before retracing back to target by end-2027. And while the ECB might still want to raise rates by a further 25bps in Q3 to take the deposit rate to 2.50% – the upper end of its range of neutral – we would see no need for it to push it any higher than that.

The day ahead in the euro area

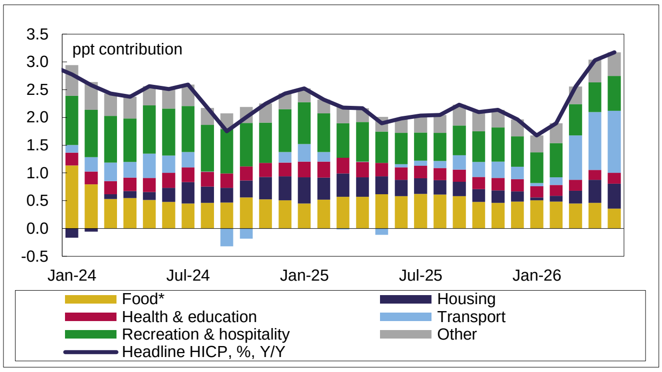
In terms of euro area data, Thursday should be relatively quiet. April's construction output data will provide further insight into GDP at the start of Q2. And much like the industrial sector figures, we expect the data to suggest the likelihood of a rebound in production this quarter. Overall, however, we expect a modest expansion in April thanks principally to the firm pickup of 2.4%M/M in Germany.

Euro area: Monthly change in HICP inflation



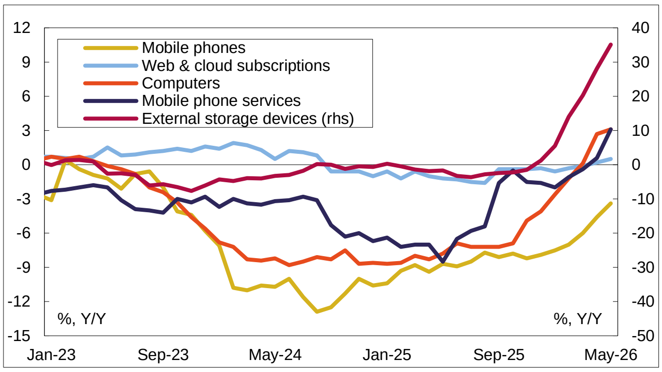
*Non-energy industrial goods.
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Contributions to HICP inflation



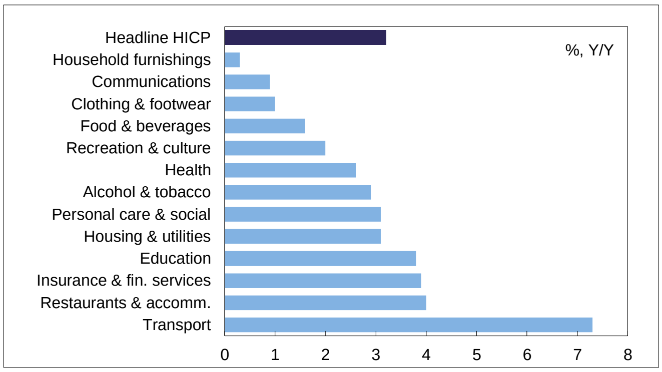
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Selected ICT goods & services inflation



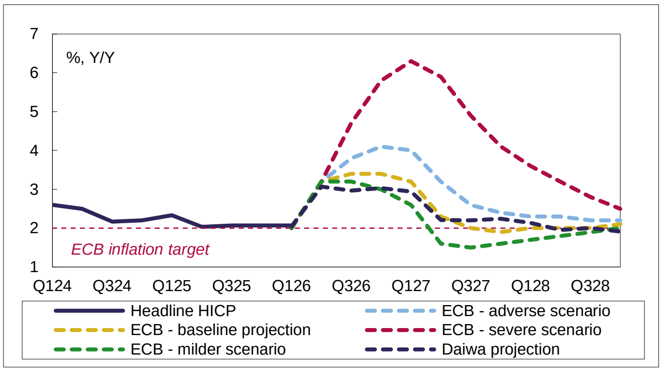
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Inflation by category (May-26)



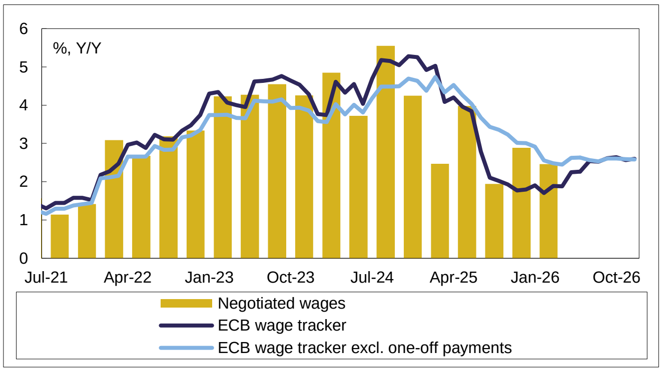
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Inflation projections



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

Euro area: ECB wage tracker & negotiated wages



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

UK

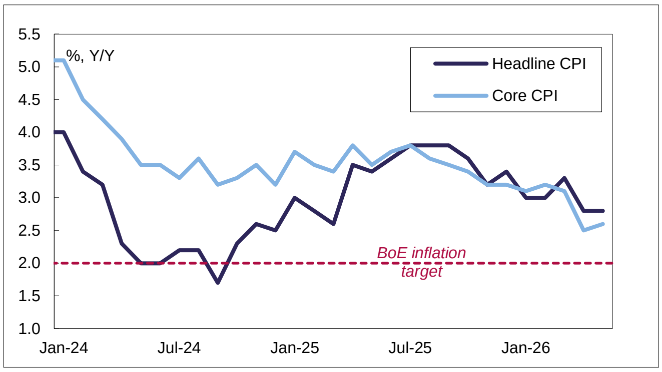
UK inflation undershoots expectations, reinforcing expectations of unchanged Bank Rate this week

Ahead of tomorrow's BoE policy announcement, today's softer-than-expected UK inflation print underscored the likelihood that Bank Rate will be left unchanged at 3.75% tomorrow. Taken together with the downside surprise in April and a more benign inflation outlook driven by the past week's drop in wholesale energy prices, the case for policy remaining on hold over coming quarters has strengthened too. Indeed, contrasting expectations of a rise, headline inflation merely moved sideways in May at 2.8%Y/Y, marking the joint-lowest level since March 2025 and coming 0.5ppt below the BoE's end-April projection. While core inflation edged up slightly, by 0.1ppt to 2.6%Y/Y, this was still the second-lowest rate since mid-2021. Moreover, as in the euro area, the rise largely reflected a correction to temporary factors and other one-offs in certain services. The largest impetus stemmed from transport services including the base effect relating to last year's vehicle excise duty error. In addition, airfares rose 10%M/M compared with a near-5%M/M decline a year ago, likely in part a consequence of higher jet fuel costs but also a rebound from temporary weakness related to the timing of Easter. Overall, services inflation increased 0.5ppt to 3.7%Y/Y, only partially reversing the drop in April. And when excluding indexed and volatile items, a measure of underlying services watched by the BoE merely moved sideways at 3.9%Y/Y, just 0.1ppt above the four-year low reached in September. Similar to the euro area, inflation of ICT-related services and goods edged higher. But overall core goods inflation fell to a 19-month low of 0.7%Y/Y, pointing to weak pricing power amid subdued demand across a range of goods including clothing, furniture and household appliances. As in the euro area, food inflation also surprised to the downside, dropping to 2.2%Y/Y, the lowest rate in 4½ years and around half the rate anticipated by the BoE. And while energy inflation rose to a three-year high (7.4%Y/Y), there was a welcome moderation in prices of auto fuel and heating oil, albeit leaving them still up by more than a third and double the respective levels a year earlier.

Inflation likely to peak slightly below the BoE's best-case scenario on lower energy futures curves

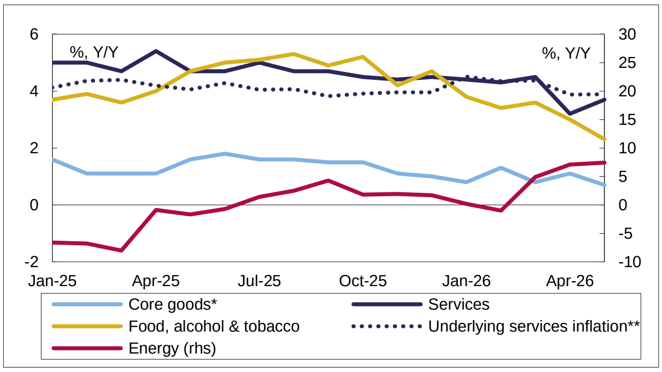
Notwithstanding the likelihood of a further decline in petrol and diesel prices in June, energy inflation will rise sharply in July as the near-13% increase in the Ofgem household tariff cap pushes it into double digits. However, assuming the US-Iran deal is adopted and implemented, that should mark the peak. Wholesale gas and oil prices so far in Q2 are well below the Bank's assumption in its projections. And futures curves are currently tracking close to or below its best-case scenario, implying that energy could well become a drag on headline inflation from Q127 onwards. Despite a further rise in producer input costs in May, to be up some 8½% since the start of the year, broader pipeline pressures outside of energy components remain limited, suggesting that the upwards trend in underlying goods inflation should be broadly contained. Although fertilizer prices will eventually feed through to food inflation, that peak should remain below last year's highs and the double-

UK: Headline & core inflation



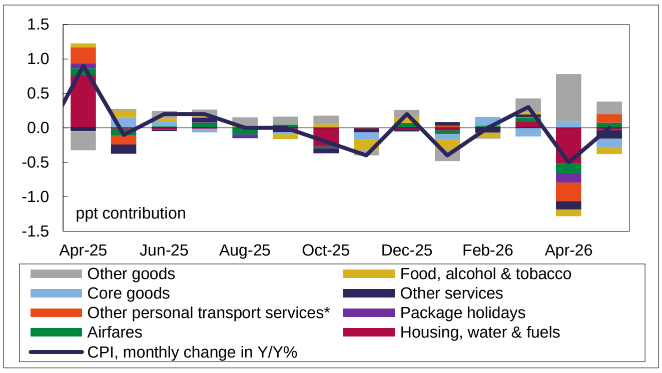
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Key inflation components



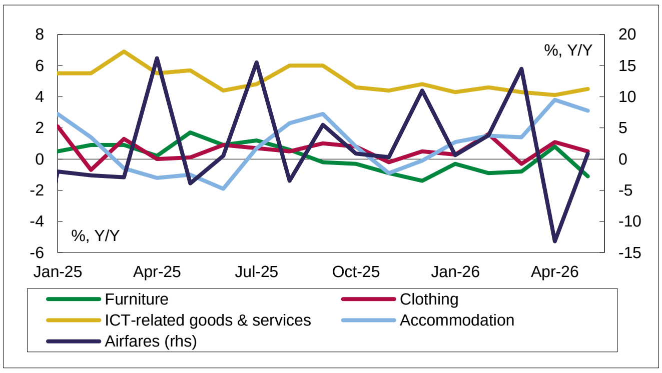
**Non-energy industrial goods. **Excluding indexed and volatile items.*
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Monthly change in CPI inflation



**Including vehicle excise duty.*
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Selected services & goods inflation components



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

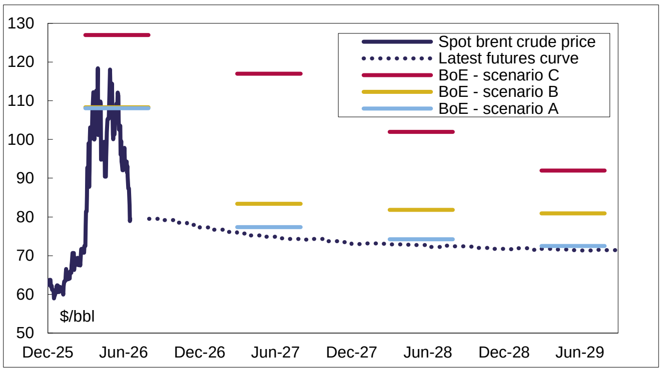
digit rates recorded in the aftermath of the 2022 energy shock. And while services inflation will move gradually higher over coming quarters and could peak close to 4½%Y/Y in April next year when certain components are reindexed, soft labour demand will limit second-round inflation effects via pay growth. Of course, the near-term outlook is subject to significant uncertainty. But we now forecast that headline inflation will peak below 3½%Y/Y this year, a touch below the BoE's scenario A, before taking a step down in Q227 back close to 2½%Y/Y and moving gradually lower thereafter. Given our expectation for inflation to return to the 2% target from H228, we now expect Bank Rate to be held steady at 3.75% into early next year, before the MPC cuts rates in Q227.

The day ahead in the UK

All eyes in the UK on Thursday will be on the BoE's monetary policy announcement. Unlike the ECB's decision last week, the MPC is widely expected to leave policy unchanged for a fourth consecutive meeting, holding Bank Rate at 3.75%. Among the rate-setters, Chief Economist Huw Pill is bound to maintain his calls for tighter policy. And we suspect that he will be joined this time by external member Megan Greene, who set out in a speech earlier this month her case for why higher rates might very soon be needed to mitigate second-round inflation effects (see full BoE preview and table of policymakers' comments in last Friday's Euro wrap-up). We had also earmarked both Deputy Governor Lombardelli and external member Mann as potential voters for a hike too, given their hawkish dissents in the past, and recent increases in consumer inflation expectations. But recent news regarding a US-Iranian agreement and the subsequent decline in global energy prices might have diminished that likelihood. And we still strongly expect the remaining five members, including Governor Bailey, to vote to leave Bank Rate unchanged this month, which reinforces our expectation for only a modestly more hawkish split on the MPC (7-2) than in April.

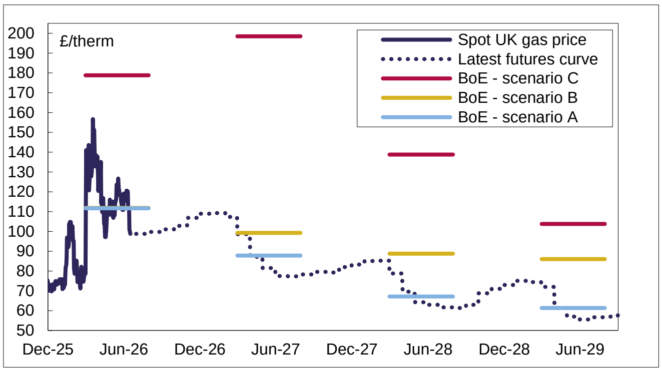
Certainly, the majority will emphasise that uncertainty remains high, and that there are upside risks to the inflation outlook. But a majority will also likely agree that the tightening of financial conditions since the outbreak of conflict in the Middle East, coupled with the MPC's 'active' recent decisions to hold policy rather than deliver the cuts priced by the markets earlier in the year, are leaning against those upside risks. Rate-setters might also take comfort from the decline in the energy price forward curves are now being priced close to or below the BoE's more-dovish scenario A, which had seen inflation undershooting the BoE's inflation target at the end of the policy horizon. As such, if the relief in energy markets holds, we would also be unsurprised if some of the MPC's more dovish members were to signal that holding the current monetary policy stance might suffice before a rate cut next year.

UK: Brent crude futures & BoE assumptions*



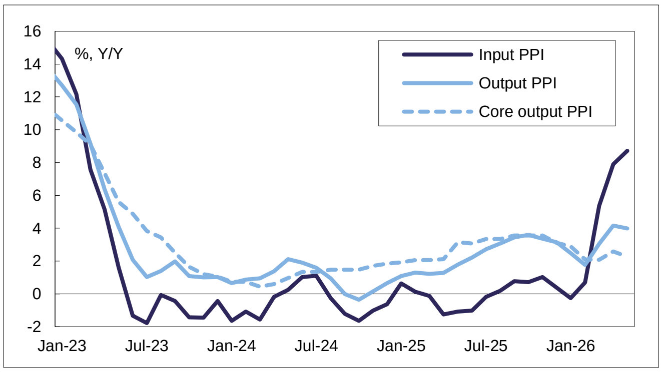
Lines for the BoE show conditioning assumptions in Q2 of each year. Source: Bloomberg, BoE MPR Apr-26 and Daiwa Capital Markets Europe Ltd.

UK: Natural gas futures & BoE assumptions*



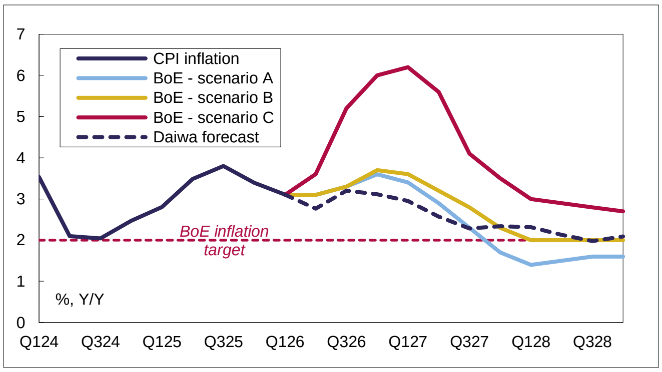
Lines for the BoE show conditioning assumptions in Q2 of each year. Source: Bloomberg, BoE MPR Apr-26 and Daiwa Capital Markets Europe Ltd.

UK: Producer price inflation



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Inflation projections



Source: BoE MPR Apr-26, Macrobond and Daiwa Capital Markets Europe Ltd.

Moreover, the latest UK labour market report – which will be published shortly before the BoE's announcement – should also serve policymakers a reminder of how persistent slack in the labour market is likely to mitigate risks of second-round effects via wages. In particular, the BoE's preferred wage measure (i.e. private regular pay growth) is expected to decelerate to 2.9%3M/Y in April, the first sub-3% reading in 5½ years, and consistent with an undershooting of the BoE's most dovish scenario projection (A). We also see the risks to the unemployment rate as skewed firmly to the upside, given the warning signs of weak labour demand from business surveys and rising redundancy notices. We note, however, that the marked deterioration in April's preliminary payroll estimate (-100k) is highly likely to be revised for the better.

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	**3.2 (2.6)**	*3.2 (2.5)*	3.0 (2.2)	-
UK	Headline (core) CPI Y/Y%	May	**2.8 (2.6)**	*3.1 (2.8)*	2.8 (2.5)	-
	PPI – output (input) prices Y/Y%	May	**4.0 (8.7)**	4.0 (8.8)	4.0 (7.7)	-
	House price index Y/Y%	Apr	**3.8**	-	0.0	-

Auctions

Country	Auction
Germany	sold €971mn of 3.4% 2047 bonds at an average yield of 3.40%
	sold €1.136bn of 1.8% 2053 bonds at an average yield of 3.49%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

Country	BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Euro area	09.00	ECB current account €bn	Apr	-	14.9
	10.00	Construction output M/M% (Y/Y%)	Apr	-	0.8 (-1.2)
UK	07.00	Average wages (excluding bonuses) 3M/Y%	Apr	4.0 (3.2)	4.1 (3.4)
	07.00	Private sector regular wages 3M/Y%	Apr	*2.9*	3.0
	07.00	Unemployment rate 3M%	Apr	5.0	5.0
	07.00	Employment 3M/3M change 000s	Apr	73	148
	07.00	Payrolled employment M/M change 000s	May	-23	-100
	07.00	Claimant count rate % (change 000s)	May	-	4.4 (26.5)
	12.00	BoE Bank Rate %	Jun	*3.75*	3.75

Auctions and events

Country	BST	Event
France	09.50	Auction: to sell up to €14bn of 2.4% 2029, 3.25% 2032, 2% 2032 and 3% 2034 bonds
	10.50	Auction: to sell €1.5bn of 3.15% 2032, 0.1% 2038, and 1.8% 2040 inflation-linked bonds
Spain	09.30	Auction: to sell 3% 2033, 2.4% 2036 and 4.9% 2040 bonds
UK	12.00	BoE monetary policy announcement, statement and minutes to be published

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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