Euro wrap-up

Overview

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- Bunds followed USTs lower, while the euro area trade balance flipped into deficit in May in part due to higher fuel prices.
- While BoE Deputy Governor Breeden played down the need to raise rates, Gilts made losses after UK GDP exceeded expectations in May higher services and manufacturing output.
- Friday will bring final euro area inflation figures for June, while Andy Burnham will be confirmed as the new leader of the UK Labour Party.

Daily bond market movements

Bond	Yield	Change
BKO 2.7 09/28	2.751	+0.021
OBL 2½ 04/31	2.845	+0.015
DBR 3 08/36	3.131	+0.013
UKT 4⅜ 03/28	4.331	+0.024
UKT 4⅛ 03/31	4.510	+0.016
UKT 4¾ 10/35	4.960	+0.023

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

Euro area

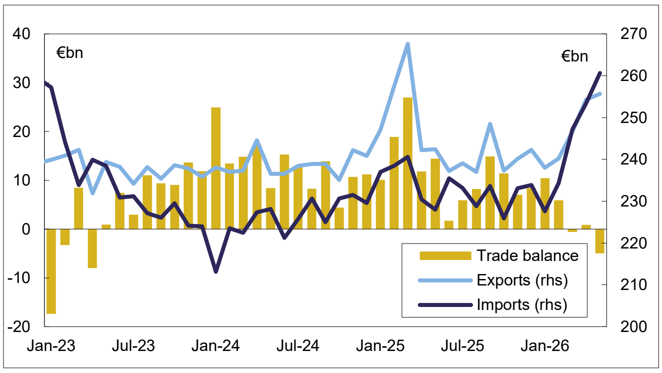
Trade balance flips into deficit on higher fuel imports

Contrasting the improvement in Germany in May, the euro area goods trade balance unexpectedly deteriorated significantly. On a seasonally adjusted basis, the surplus of €0.8bn in April flipped to a deficit of €5.0bn, the biggest in more than three years. The value of goods exports rose for a fourth successive month in May and by 0.6%M/M to be up 5.0%3M/3M and reach the highest level since March 2025 ahead of Trump's "Liberation Day" tariff announcement. But, on the same basis, imports also rose for the fourth month in a row and by a larger 2.8%M/M to be up 9.4%3M/3M and hit the highest level since late 2022. Of course, that larger surge in the value of imports in part reflects the shock to prices of energy and other commodities resulting from events in Middle East. Indeed, two-thirds of import growth on a three-month basis came from mineral fuels and crude materials. And in April (the most recent month for which data exists), growth in export volumes (2.5%M/M and 1.8%3M/3M) significantly outpaced that of imports (-1.3%M/M and 0.3%3M/3M) despite the opposite being true in value terms. In May, export value growth was principally concentrated in chemicals and pharmaceuticals, with most other components softer. But on a three-month basis, it was broad-based with machinery and transport goods, mineral fuels and other commodities also making non-negligible contributions to the upswing.

Lowest trade surplus with US since 2023, highest deficits with China since 2022

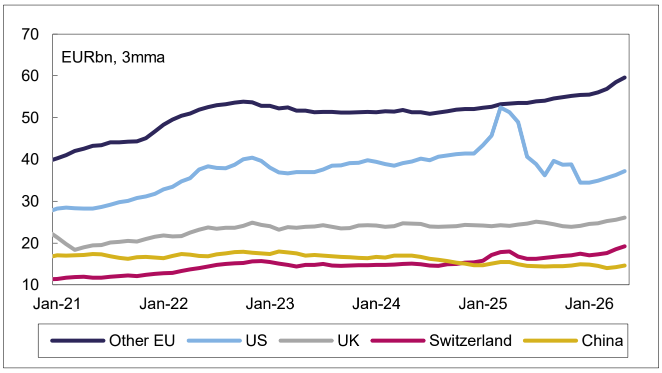
By destination, export growth in May was similarly broad-based on a three-month basis. Shipments rose to the US (6.5%3M/3M), other EU countries (6.4%3M/3M), the UK (5.4%3M/3M) and Switzerland (11.0%3M/3M), but were much more sluggish to China (0.5%3M/3M). A little more than half of export growth to the US was accounted for by machinery and transport goods while chemicals were also stronger. But given the shock of tariffs, compared to a year earlier, shipments to the US were still down almost 14%Y/Y, with chemicals exports down more than one third and the only significant growth in machinery and transport items (6.5%Y/Y). And with mineral fuel imports from the US up sharply to a record high, the euro area trade surplus with the US narrowed by almost €1bn to €7.6bn, the smallest in more than three years. Meanwhile, imports from China were little changed on the month. But on a three-month basis they were up a firm 3.6%3M/3M, far outpacing euro area exports to China and almost fully accounted for by increased deliveries of machinery and transport goods. And the euro area's bilateral trade deficit with China was minimally changed at €26.2bn, a level bar April's that has only been larger in certain months of 2022. While a new EU-China Trade and Investment Consultations (TIC) forum has been established to find a 'more balanced' trade relationship, it currently seems hard to envisage concrete progress before October's deadline for 'tangible results', especially without significant adjustment to the renminbi exchange rate. So, unilateral remedial trade measures from the EU, such as new barriers to access to public procurement contracts and acquisitions of European firms, might appear increasingly likely.

Euro area: Trade values



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Export values by destination

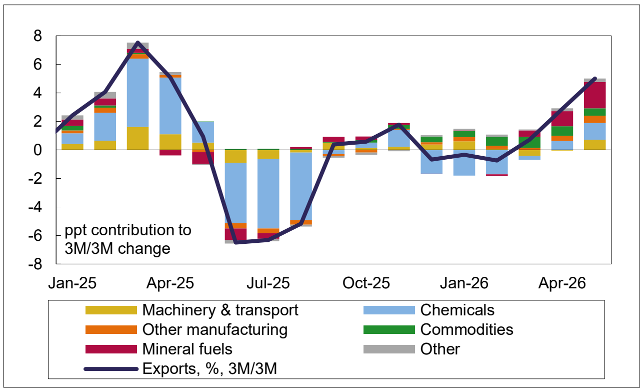


Source: Macrobond and Daiwa Capital Markets Europe Ltd.

The day ahead in the euro area

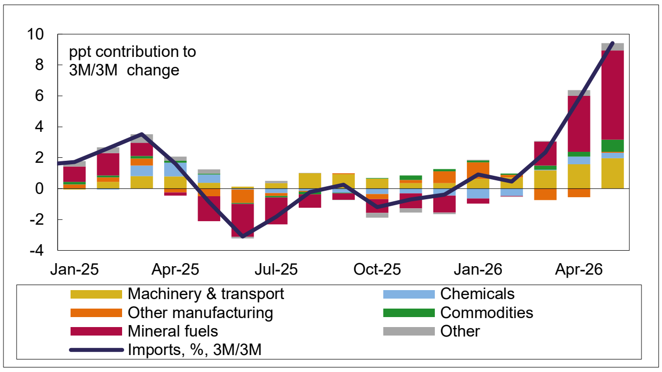
Today's modest downwards revision to Italian HICP inflation in June (to 3.0%Y/Y) should be of little consequence to Friday's final euro area release. The data will be expected to confirm an encouragingly soft flash reading, which showed that headline inflation eased by more than expected in June (by 0.4ppt), to a three-month low (2.8%Y/Y). The accompanying detail is likely to attribute most of that decline to softening fuel prices. Household energy might have raised its contribution owing to pressures in Southern Europe. But the flash release implied that the moderation from transport fuel was larger, pushing energy inflation (8.7%Y/Y) down around 2ppts from its recent peak. With the impacts of higher fertiliser prices and extreme weather still in the pipeline, food inflation should be confirmed as having eased to a near-five year low (1.6%Y/Y) reflecting a softening across each of the largest member states. The apparent absence of broader pass-through from energy inflation to core components should also be of some reassurance to policymakers, albeit with the recent reescalation of the conflict in the Middle East having since reinvigorated concerns about upside inflation risks. We expect core inflation will be confirmed as having eased back to its pre-war rate (2.4%Y/Y, down 0.2ppt), which the national detail suggest was at least partly reflective of weaker indirect effects via passenger airfares.

Euro area: Growth in export values & contributions



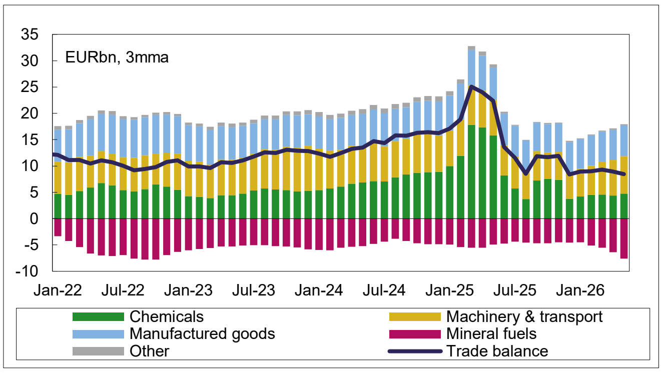
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Growth in import values & contributions



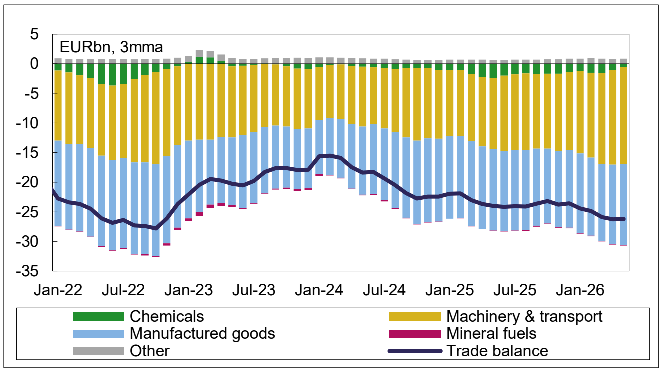
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Bilateral goods trade balance with the US



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Bilateral goods trade balance with China



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK

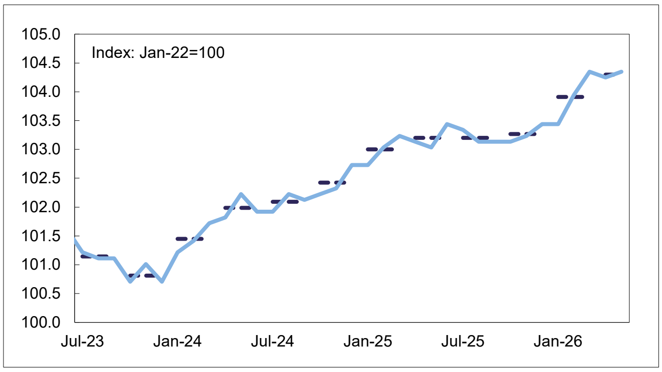
GDP returns to growth in May keeping Q2 expansion on solid footing

Today's UK GDP data beat expectations, suggesting that the economy remained resilient in the middle of Q2 despite headwinds from the conflict in the Middle East. GDP returned to modest growth in May, rising 0.1%M/M to reverse April's contraction. Supported by the strong carryover from Q1, growth on a three-month basis eased only marginally from April's near-two-year high to a still robust 0.7%3M/3M. Admittedly, surveys suggest that momentum has slowed since the spring and point to weakening in June. But the heatwave and FIFA World Cup are likely to have provided some support at the end of the quarter. As such, we have revised up our estimate for Q2 GDP growth by 0.2ppt to 0.4%Q/Q. While that would represent a moderation from growth of 0.6%Q/Q in Q1, it would nevertheless again exceed the BoE's projection (0.1%Q/Q). Of course, Bank staff continue to judge that underlying GDP growth is softer than the headline figures imply. The squeeze on household budgets from higher energy tariffs, soft labour demand and subdued confidence pose a downside risk to consumption over the near term. Supply bottlenecks, cost pressures, uncertainty and tighter financial conditions might also act as a headwind to business and construction investment. And consistent with recent seasonal patterns, we expect recorded GDP growth to slow further in H226 to perhaps no stronger than 0.1%Q/Q in both Q3 and Q4 alike.

AI-related demand supporting services and manufacturing

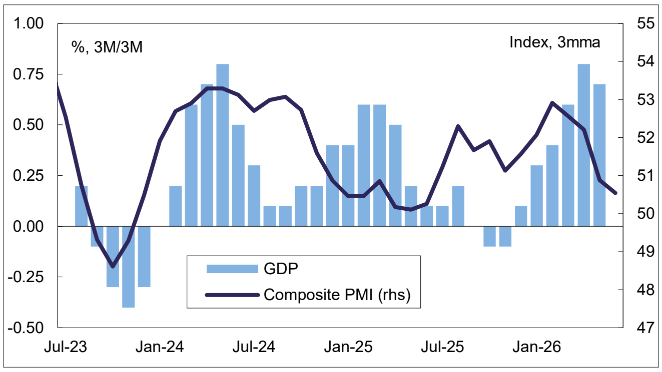
The return to growth in May was driven entirely by services output, which rose 0.3%M/M, leaving three-month growth at a still robust 0.7%3M/3M. The expansion was led by a near-5%M/M surge in R&D, lifting activity in that subsector to the highest level in 11 months. Meanwhile, strong AI-related demand boosted computer programming and related services to a new high, up 5½%Y/Y and trending so far in Q2 almost 3% above its Q1 average. Consumer-facing services remained resilient too, rising 0.5%3M/3M, supported in part by accommodation and perhaps reflecting stronger demand for staycations. By contrast, travel agency activity in the first two months of Q2 remained below its Q1 average, while legal services were likely restrained by a sharp decline in residential property transactions amid more elevated borrowing costs and housing market uncertainty. While construction activity fell in May by 0.8%M/M, this merely marked the first monthly decline in five. And despite reports of supply disruption in the sector, new building work remained on track to deliver the first quarterly expansion in a year. The manufacturing data also provided little evidence that supply pressures were becoming more binding. Factory output rose for a third consecutive month (albeit by just 0.1%M/M) to match the highest level in almost three years, led by a more than 5%M/M increase in machinery and equipment production. Production of ICT equipment rose to a series high, trending almost 3% above the Q1 average. And pharmaceuticals output was tracking more than 6% above the Q1 level. So, while energy production in May appears to have provided a non-negligible drag last quarter, manufacturing is on track for a third consecutive quarterly increase and by more than 1%Q/Q.

UK: GDP level*



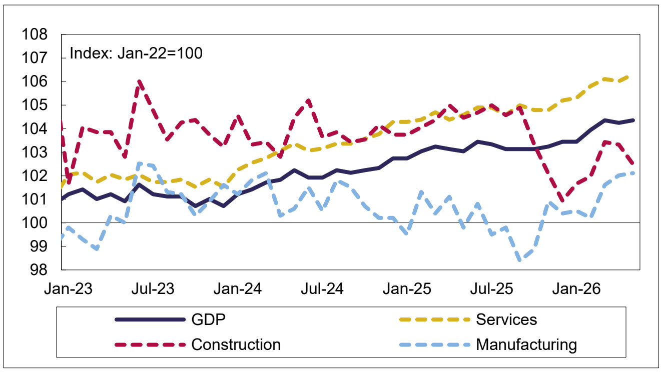
*Dashed dark blue line represents quarterly average.
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: GDP growth & composite output PMI



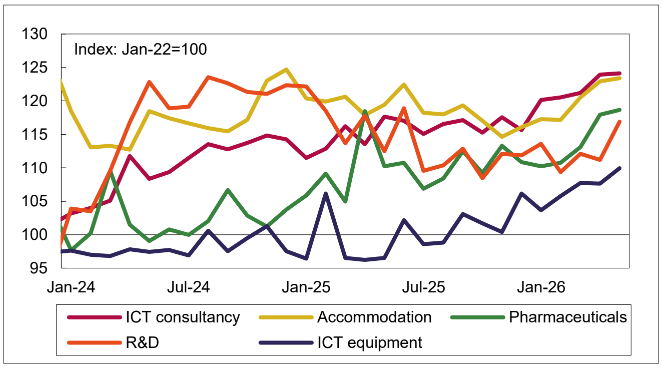
Source: Macrobond, S&P Global and Daiwa Capital Markets Europe Ltd.

UK: Monthly GDP by sector



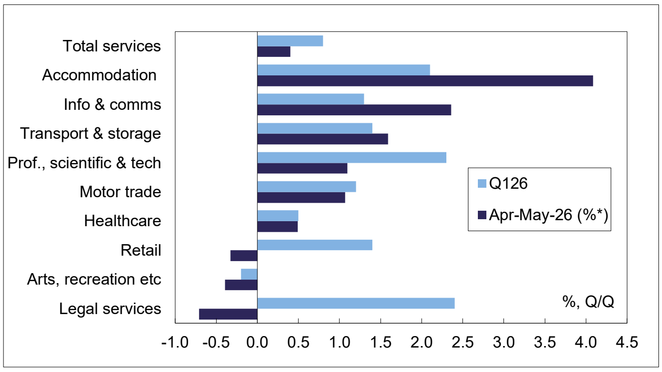
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Output in selected subsectors



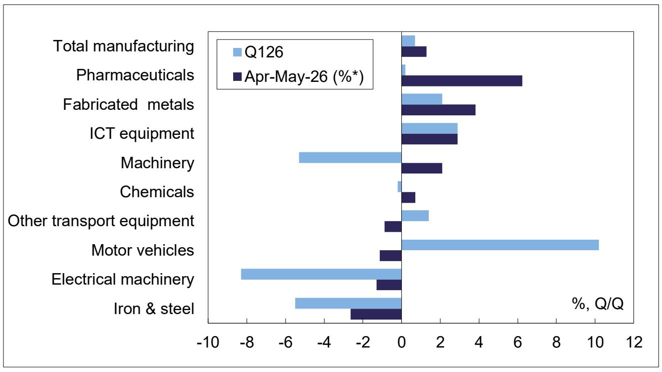
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Growth in selected services sectors



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Growth in selected manufacturing sectors



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

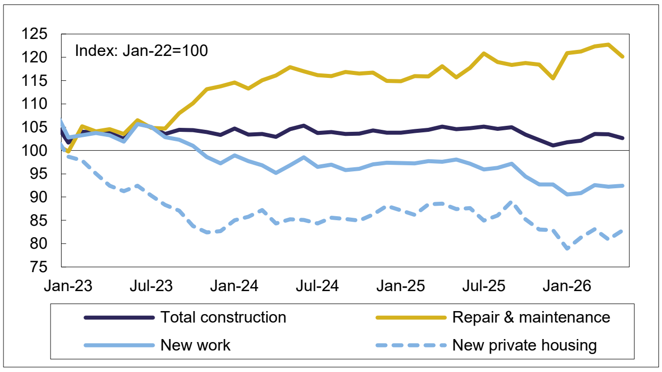
Underlying export volumes up to series high in May on firmer goods shipments

Firm expansion in manufacturing output in Q2 appears to have corresponded with a second successive quarter of growth in goods exports. Excluding precious metals, underlying goods export volumes rose £1.6bn (5.2%M/M) in May to a 15-month high, trending almost 2½% above the Q1 average. Growth was relatively broad-based across sub-sectors, but firmest in shipments of pharmaceuticals and other chemicals and non-ferrous metals to the US. Underlying goods imports were also up in May, albeit at a softer pace (1.4%M/M) than exports. Export and import volumes of services edged down very slightly in May to be trending little changed in Q2 from Q1. But that meant that total export volumes excluding precious metals rose to a series high. Meanwhile, shipments of precious metals were up sharply while imports of such items fell. So, total export volumes were trending about 1½% above the Q1 average in the first two months of Q2 while import volumes were up little more than half that pace. As a result, net trade looks to have made a positive contribution to GDP growth in Q2 for the first time in three quarters. Including price effects, total export values rose £2.3bn (2.8%M/M) while import values fell £3.7bn (4.3%M/M). So, the total trade deficit fell some £6.0bn to a four-month low of just £1.0bn. Excluding precious metals, the underlying trade deficit narrowed a smaller £1.2bn to £1.9bn, nevertheless similarly a four-month low.

The day ahead in the UK

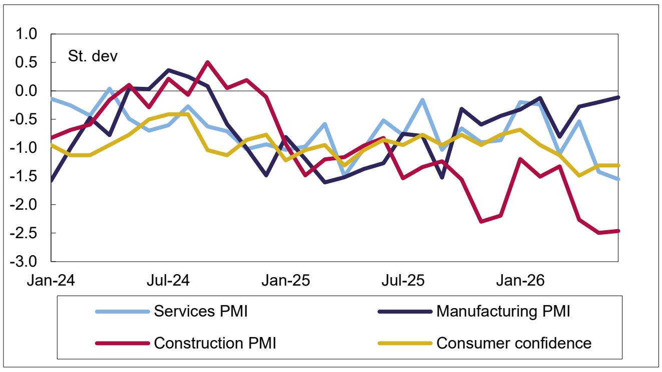
While Andy Burnham will be announced as the new leader of the governing Labour Party on Friday, he is not expected to be formally sworn in as Prime Minister until the beginning of next week. And with no economic data otherwise scheduled, it should be a quiet end to the week for the UK.

UK: Construction activity



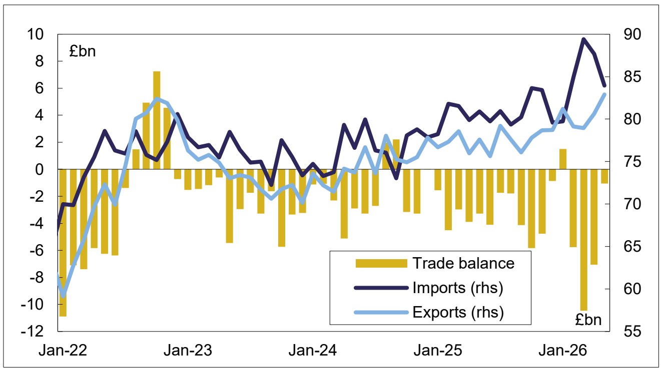
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Business & consumer confidence indices



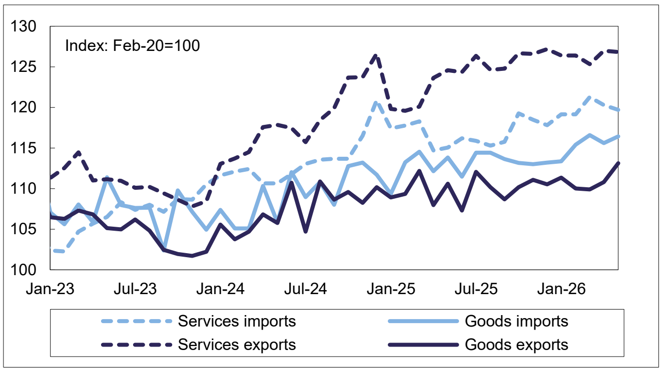
Source: Macrobond, S&P Global, GfK and Daiwa Capital Markets Europe Ltd.

UK: Trade values*



**Includes precious metals.*
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Underlying export & import volumes*



**Excludes precious metals.*
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

European calendar

Today's results

Economic data

Country		Release	Period	Actual	Market consensus/ Daiwa forecast	Previous	Revised
Euro area		Trade balance €bn	May	**-5.0**	2.5	1.3	0.8
Italy		Final HICP (CPI) Y/Y%	Jun	**3.0 (3.0)**	3.1 (3.0)	3.2 (3.2)	-
UK		Monthly GDP M/M% (3M/3M%)	May	**0.1 (0.7)**	0.0 (0.5)	-0.1 (0.7)	- (0.8)
		Services output M/M% (3M/3M%)	May	**0.3 (0.7)**	0.1 (0.6)	-0.2 (0.8)	-0.1 (0.9)
		Industrial output M/M% (Y/Y%)	May	**-0.5 (1.0)**	-0.1 (1.3)	0.0 (-0.2)	0.2 (0.0)
		Construction output M/M% (Y/Y%)	May	**-0.8 (-1.8)**	-0.3 (-1.2)	0.1 (-1.0)	-0.1 (-1.6)
		Trade (goods trade) balance £bn	May	**-1.0 (-18.7)**	-5.5 (-23.1)	-8.4 (-26.0)	-7.1 (-24.6)

Auctions

Country		Auction
France		sold €3.997bn of 2.4% 2029 bonds at an average yield of 3.04%
		sold €2.85bn of 1.5% 2031 bonds at an average yield of 3.23%
		sold €4.887bn of 3.25% 2032 bonds at an average yield of 3.35%
		sold €2.285bn of 3.5% 2033 bonds at an average yield of 3.58%
		sold €675mn of 0.1% 2032 inflation-linked bonds at an average yield of 1.81%
		sold €415mn of 1.8% 2040 inflation-linked bonds at an average yield of 1.99%
		sold €320mn of 0.1% 2053 inflation-linked bonds at an average yield of 2.29%
Spain		sold €2.61bn of 2.35% 2029 bonds at an average yield of 2.867%
		sold €1.77bn of 3.55% 2033 bonds at an average yield of 3.297%
		sold €1.59bn of 3.95% 2056 bonds at an average yield of 4.286%
UK		sold £4.25bn of 4.875% 2036 bonds at an average yield of 5.04%

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	May	-	15.7
		10.00	Final headline (core) HICP Y/Y%	Jun	2.8 (2.4)	3.2 (2.6)

Auctions and events

- Nothing scheduled -

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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