Euro wrap-up

Overview

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- Bunds were little changed as flash euro area inflation data fell short of the consensus expectation but unemployment in the region declined again.
- Gilts followed USTs lower despite weak surveys for UK retail sales and construction activity.
- Wednesday brings new data for euro area retail sales and final services PMIs for the euro area and UK.

Daily bond market movements

Bond	Yield	Change*
BKO 0 06/21	-0.646	+0.005
OBL 0 04/24	-0.569	+0.001
DBR 0¼ 02/29	-0.207	-0.007
UKT 1½ 01/21	0.613	+0.022
UKT 1 04/24	0.652	+0.038
UKT 1⅝ 10/28	0.900	+0.038

*Change from close as at 4.30pm BST.
Source: Bloomberg

Euro area

Inflation drops to 13-month low

As had been suggested by the equivalent figures from the larger member states released last week, the flash estimate of euro area inflation fell 0.5ppt to a thirteen-month low of 1.2%Y/Y in May. That more than reversed the 0.3ppt increase in April, which was primarily related to the impact of the timing of Easter on various prices of services, particularly package holidays. Indeed, services inflation in May fully reversed the increase the previous month, falling back 0.8ppt to 1.1%Y/Y. So, although inflation of non-energy industrial goods edged up 0.1ppt to 0.3%Y/Y, core inflation fell 0.5ppt to 0.8%Y/Y, matching March's rate of 0.8%Y/Y, which was only just above the bottom of the range of the past four years. Among non-core items, food inflation edged up to 1.6%Y/Y, but still represented the second-lowest reading in more than a year. And energy inflation dropped 1.5ppts to 3.8%Y/Y.

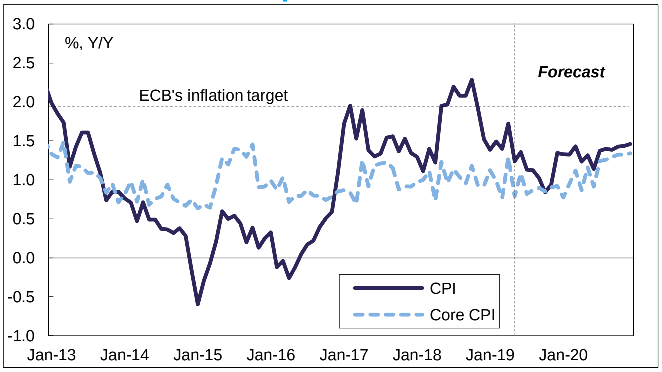
Underlying inflation to remain subdued

Looking ahead, we expect a moderate rebound in services inflation in June to push the core CPI rate back above 1.0%Y/Y. But that shift looks likely to be short-lived. Indeed, we expect core inflation to average less than 1.0%Y/Y throughout the second half of the year. And with energy inflation set to subside over coming months, headline inflation should also fall below 1.0%Y/Y by October, before ticking up again at the turn of the year. Overall, we forecast headline inflation to average just 1.2%Y/Y in 2019 and 1.4%Y/Y in 2020, and core inflation to be just 1.0%Y/Y and 1.2%Y/Y – 0.2ppt below the ECB's forecast – this year and next. But there are significant downside risks to that view, associated not least with a de-anchoring of inflation expectations. Indeed, market-based measures of inflation expectations continue to decline, with the 5Y5Y inflation swap forward rate down again today to below 1.29%, rapidly closing in on the all-time low of 1.25%.

Unemployment keeps falling

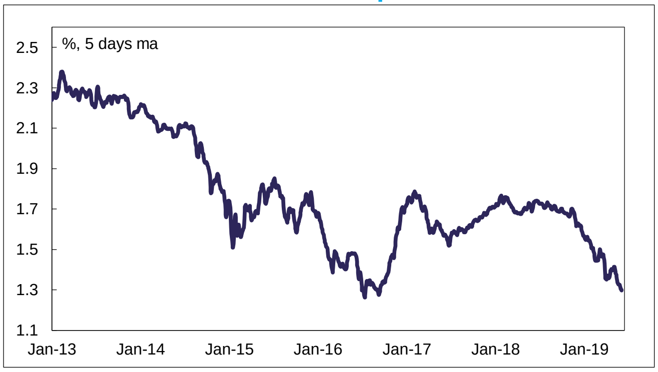
While underlying inflation continues to disappoint ECB expectations, unemployment keeps falling faster than anticipated. The euro area unemployment rate dropped 0.1ppt for the second successive month in April, declining to 7.6%, down 0.8ppt from a year earlier and 4.5ppts from the post-crisis peak, and the lowest since August 2008. The number of people out of work fell for the sixth consecutive month, albeit by a relatively modest 64k, to 12.53mn. That took the cumulative decline from a year earlier to 1.15mn, and the decline from the peak to 6.85mn. At the country level, Spain was the only one of the larger member states to see a decline in the jobless rate, with a drop of 0.2ppt in April to 13.8%, 12.5ppts below the peak and the lowest since November 2008. And Spanish Labour Ministry data also released today showed a further decline of 84k in registered unemployment in May, and a further rise in employment closer to the pre-crisis peak. Looking ahead, not least due to ongoing improvements in Spain, we expect the euro area unemployment rate to decline further over the remainder of the year, to 7.4% by December. After growth in negotiated wages edged up in Q1 to 2.2%Y/Y, the strongest since Q412, the favourable trend in joblessness should support a continued gradual upwards

Euro area: Consumer price inflation



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Euro area: 5Y5Y Inflation swap forward rate



Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

drift in labour cost growth. However, evidence to date in the euro area and other major economies suggests that is likely to provide only a modest, rather than substantive, positive impulse to core inflation next year.

The day ahead in the euro area and US

Wednesday will bring euro area retail sales data for April as well as the final services and composite PMIs for May. Having moved sideways in March to take the gain over Q1 as a whole to 0.7%Q/Q, euro area retail sales are expected to decline about ½%M/M at the start of Q2, not least as sales dropped a sharp 2.0%M/M in Germany. Meanwhile, the PMIs are highly likely to align closely with the preliminary estimates for which the euro area services PMI fell 0.3pt to 52.5, a five-month low, and the composite PMI inched up just 0.1pt to 51.6. (The final euro area manufacturing output PMI, released yesterday, was revised down just 0.1ppt to 48.9).

In the US, the non-manufacturing ISM survey for May will be released along with the Fed's Beige Book, the final Markit services and composite PMIs, and – ahead of Friday's official labour market report – the ADP employment numbers. Fed speakers include Vice Chair Richard Clarida.

UK

Construction PMI suggests contraction in May

All evidence points to a notable weakening of UK economic activity in May. The manufacturing PMI, released yesterday, declined for the fifth month out of the past six and by a sizeable 3.7pts, to 49.4, the lowest since the post-referendum slump in July 2016 and only the second sub-50 reading in more than six years. And today's equivalent construction survey also indicated contraction last month, with the headline PMI dropping 1.9pts to 48.6, the lowest since March 2018 when activity was hampered by snow. The detail suggested significant deterioration in commercial activity and civil engineering, for which the respective PMIs fell more than 1½pts to 46.0 and 46.4, both the worst since September 2017. In contrast, house-building activity seemingly continues to grow, albeit moderately, with the sub-sector's PMI down 0.9pt to 52.3. The survey also suggested that the sector shed workers in May by the most since November 2012. And a decline of 0.7pt in the new orders PMI to 47.9, also a fourteen-month low, suggested that we should expect further contraction in total construction output over coming months. Certainly, Brexit uncertainty seems bound to weigh on commercial construction for the foreseeable future. However, increased public sector investment should provide some support for civil engineering. And, given years of undersupply, house-building should continue to grow moderately supported by low mortgage interest rates and the Government's Help to Buy Scheme for first-time buyers, despite subdued conditions in the housing market.

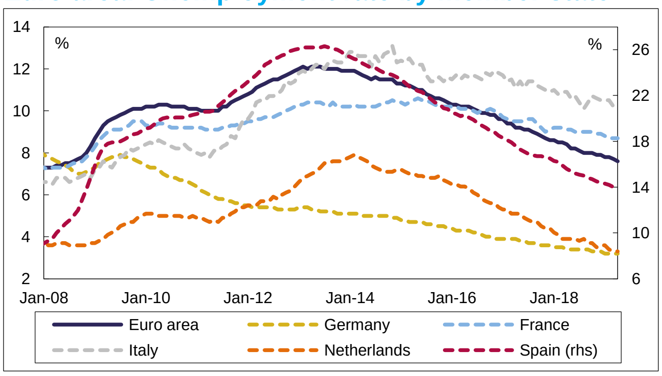
Retail sales had a bad month too

As flagged by the similar CBI survey last month, retail sales similarly appear to have had a disappointing May. Indeed, today's BRC retail sales monitor indicated a much larger-than-expected drop in retail sales in May, with the survey's measure of total sales down 2.7%Y/Y, while like-for-like sales fell 3.0%Y/Y. Admittedly, this followed notable strength in sales in April (up 4.1%Y/Y and 3.0%Y/Y respectively), partly related to the timing of Easter and unseasonably warm weather. And the annual figure for May was hardly flattered by a strong performance for the month in 2018, when sales were similarly boosted by a heat-wave, a Royal wedding and the run-up to the football World Cup. But when smoothing out the monthly volatility, the underlying message of the BRC survey was still weak. Indeed, total sales growth fell by 1ppt to just 0.2%3M/Y, the softest since March 2017, with non-food sales down 1.1%3M/Y, the most in more than a year. There was also a notable slowdown in spending online, with such sales up just 1.5%Y/Y, the weakest growth since the series began more than a decade ago.

The day ahead in the UK

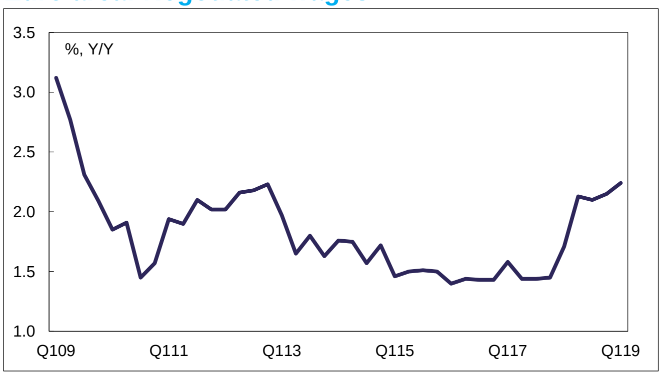
Wednesday will round off the May PMIs with the services survey. Having reached a 2½-year low of 48.9 in March, the headlines services PMI rebounded to 50.4 in April. However, in light of the weakness reported in other sectors, we expect a decline back below 50 in May, to leave the composite PMI similarly in contraction territory for the first time since July 2016.

Euro area: Unemployment rate by member state



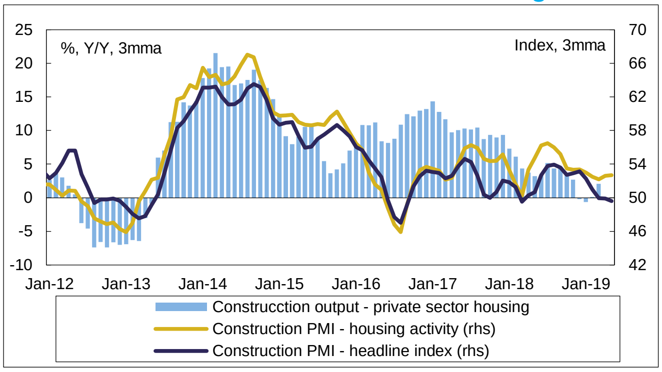
Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Euro area: Negotiated wages



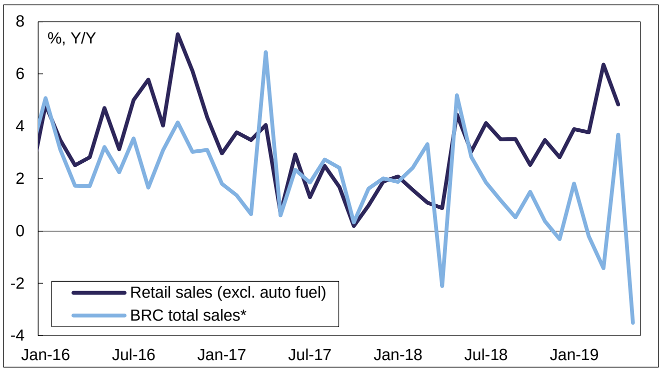
Source: ECB, and Daiwa Capital Markets Europe Ltd.

UK: Construction PMIs and house-building



Source: Thomson Reuters, Markit and Daiwa Capital Markets Europe Ltd.

UK: Retail sales volumes



**Adjusted using BRC shop price index. Source: Thomson Reuters, BRC and Daiwa Capital Markets Europe Ltd.*

European calendar

Today's results

Economic data

Country		Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
EMU		Flash CPI estimate (core CPI) Y/Y%	May	**1.2 (0.8)**	*1.2 (0.9)*	1.7 (1.3)	-
		Unemployment rate %	Apr	**7.6**	7.7	7.7	-
Italy		Unemployment rate %	Apr	**10.2**	10.3	10.2	-
Spain		Unemployment change, 000s	May	**-84.1**	-67.0	-91.5	-
UK		BRC retail sales monitor, like-for-like sales Y/Y%	May	**-3.0**	0.8	3.7	-
		Construction PMI	May	**48.6**	50.6	50.5	-

Auctions

Country		Auction
Germany sold		€368mn of 2030 index-linked bonds at an average yield of -1.15%
UK sold		£3bn of 1% 2024 bonds at an average yield of 0.612%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's data releases

Economic data

Country		BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
EMU		09.00	Final services PMI (composite PMI)	May	52.5 (51.6)	52.8 (51.5)
		10.00	Retail sales M/M% (Y/Y%)	Apr	-0.5 (1.5)	0.0 (1.9)
		10.00	PPI M/M% (Y/Y%)	Apr	0.4 (3.3)	-0.1 (2.9)
Germany		08.55	Final services PMI (composite PMI)	May	55.0 (52.4)	55.7 (52.2)
France		08.50	Final services PMI (composite PMI)	May	51.7 (51.3)	50.5 (50.1)
Italy		08.45	Services PMI (composite PMI)	May	49.8 (49.3)	50.4 (49.5)
Spain		08.00	Industrial production M/M% (Y/Y%)	Apr	0.5 (-0.2)	-1.2 (-3.1)
		08.15	Services PMI (composite PMI)	May	52.5 (52.1)	53.1 (52.9)
UK		09.00	New car registrations Y/Y%	May	-	-4.1
		09.30	Services PMI (composite PMI)	May	50.6 (50.7)	50.4 (50.9)

Auctions and events

Country		BST	Auction / Event
UK		09.00	BoE's Ramsden scheduled to speak in London

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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