Daiwa Capital Markets

Euro wrap-up

Overview

Chris Scicluna +44 20 7597 8326
Emily Nicol +44 20 7597 8331

- Bunds were little changed as data for German inflation and retail sales and euro area bank lending surprised on the downside, but the ECB's updated strategy emphasised the euro area's increased susceptibility to inflation shocks and its readiness to respond forcefully and persistently if necessary.
- Except for the superlong end of the curve, Gilts made gains despite a marked acceleration in bank lending to firms.
- Tuesday will bring the flash estimate of euro area inflation in June while Lagarde, Bailey, Ueda and Powell will speak on the ECB's Sintra policy panel.

Daily bond market movements

Bond	Yield	Change
BKO 1.7 06/27	1.853	-0.001
OBL 2.4 04/30	2.168	+0.007
DBR 2½ 02/35	2.602	-0.015
UKT 3¾ 03/27	3.809	-0.022
UKT 4⅜ 03/30	3.946	-0.017
UKT 4½ 03/35	4.487	-0.015

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

Euro area

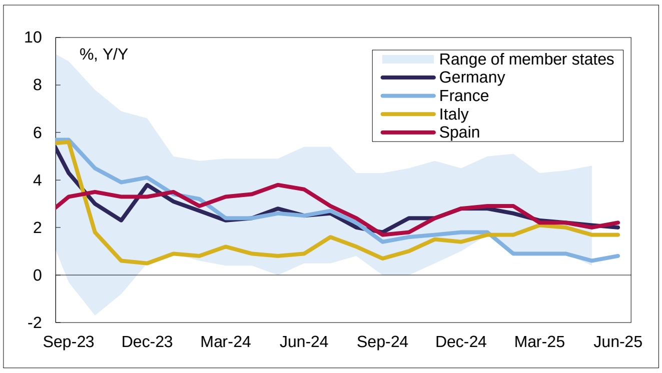
German & Italian inflation surprises on the downside to point to stable euro area in June

Contrasting the upside surprises and increases in the French and Spanish data released on Friday, today's flash inflation estimates from Germany and Italy were slightly softer than expected. As such, we maintain our forecast that euro area headline inflation moved sideways in June at a sub-target 1.9%Y/Y i. And that would leave the quarterly average for Q2 at 2.0%Y/Y, bang in line with the ECB's projection and target. On both the national CPI and EU-harmonised HICP measures, German inflation moderated by 0.1ppt to 2.0%Y/Y, 0.2ppt below the Bloomberg consensus forecast. The detail on the national measure suggested that the improvement largely reflected underlying inflation. In part due to favourable base effects and probably a sharp drop in the hotel component, German services CPI inflation moderated 0.1ppt to 3.3%Y/Y. And with non-energy industrial goods inflation down slightly too (to 1.4%Y/Y on our own estimate), probably in part due to a softening of the clothes component, German core CPI inflation (excluding food and energy) eased 0.1ppt to 2.7%Y/Y. Beyond the core, a rise of 0.9ppt in energy inflation to a three-month high (-3.5%Y/Y), resulting principally from an unfavourable base effect, was offset by a welcome drop of 0.8ppt in food inflation to a five-month low (2.0%Y/Y). Meanwhile, Italian HICP inflation moved sideways at 1.7%Y/Y for the fourth month out of the past six, with the core rate also unchanged at 1.9%Y/Y. Most importantly, services inflation was also steady (2.9%Y/Y) while non-energy industrial goods inflation remained largely absent (up marginally to 0.5%Y/Y). And beyond the core items, a further pickup in food inflation to a 16-month high (3.5%Y/Y) was offset by a cut in regulated utility prices pushing energy inflation to a six-month low (-2.5%Y/Y).

German retail sales decline in May by the most since October 2022

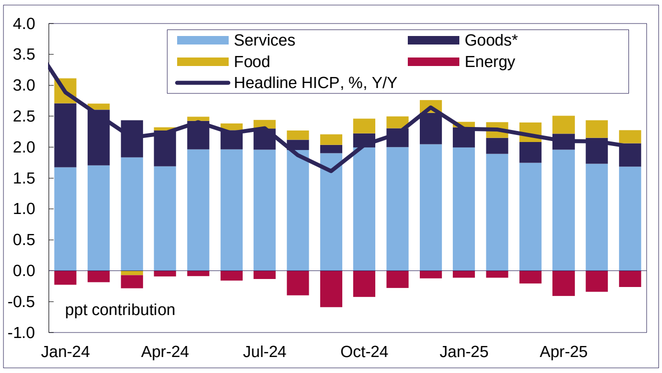
Recent signals on German consumer spending had been broadly favourable. Household consumption rose in Q1 (0.5%Q/Q) for a fourth consecutive quarter and by the most in seven. And while the GfK consumer confidence survey suggested that purchase intentions softened slightly in May, they were still close to the top of the range of the past 3½ years. Today's retail sales data for May, however, came in much weaker than expected, with volumes down for a second successive month and by the most since October 2022 (-1.6%M/M) to the lowest level in nine months. The decline was broad-based but led by the steepest drop in non-food sales (-2.2%M/M) since September 2023, which left them trending some 1.3% below the Q1 average to suggest that households were cutting back spending on non-essential items in the face of heightened economic and geopolitical uncertainties. Food sales (-1.6%M/M) also fell to a five-month low, some 0.4% below the Q1 level. As such, total retail sales volumes were trending around 0.8% below the Q1 average. Of course, German retail sales are notoriously volatile and usually subject to non-negligible revisions, with updated data for May to be published around mid-July. Furthermore, car sales appear on track to provide some offset. And with hospitality turnover in April having risen the most in

Euro area member states: HICP inflation



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Germany: CPI inflation contributions



**Goods excluding food & energy.*
Source: Destatis, Macrobond and Daiwa Capital Markets Europe Ltd.

five months (1.7%M/M), we expect spending on services to also continue to add to growth. This notwithstanding, today's data raise the risk that household consumption might provide a modest drag on GDP this quarter despite rising real incomes.

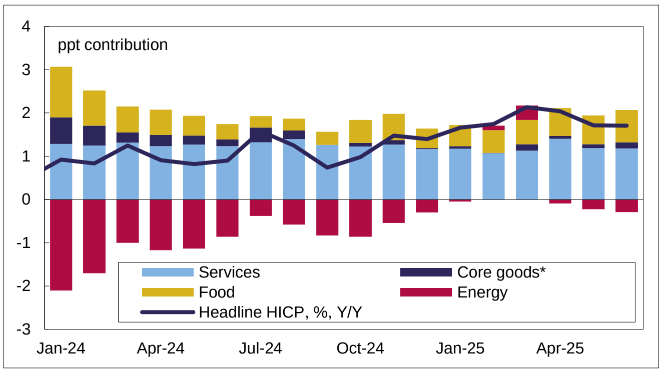
A pullback in bank lending to firms in May but recovery in mortgages maintained

Signs of weaker economic activity in Q2 were flagged by today's ECB monetary data. Net lending to non-financial corporations (NFCs) slipped into negative territory on an adjusted basis in May, and by €2.2bn, the most since January 2024. As a result, growth in the outstanding stock of loans to NFCs slowed for the first time in give months, to 2.5%Y/Y. The weakness was most acute in short-dated loans (i.e. lending with a maturity of up to one year), which tends to correspond to working capital and inventories. In contrast, net lending of longer-term loans (i.e. lending with a maturity of greater than five years), which tallies more with fixed investment, remained positive, albeit with growth picking up merely to 1.4%Y/Y. Reassuringly perhaps, the average interest rate on new loans to NFCs continues to decline, down more than 10bps in April to 3.63%, down almost 160bps from the peak in October 2023. With average rates on new mortgages also down significantly from the peak, and housing markets turning for the better, lending for home purchase maintained an uptrend in May. Net mortgage lending of €13.8bn maintained the three-month flow at above €50bn for successive months for the first time since September 2022. And that pushed up the annual rate of growth in lending for home purchase up to 2.0%Y/Y, also the most in more than two years.

Updated ECB strategy underscores readiness for forceful action given higher susceptibly to shocks

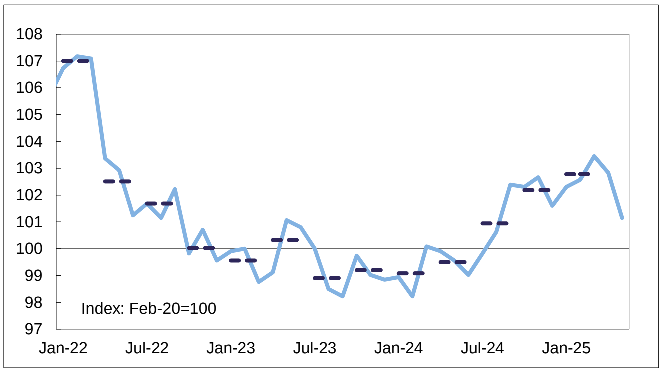
Finally, ahead of this week's annual Sintra monetary policy forum, the ECB today published its updated monetary policy strategy following the conclusion of the review conducted since March. While that review aimed to take account of key new structural trends – including heightened geopolitical uncertainty, deglobalisation risks and technological changes such as AI and stable coins – as well the recent inflation shock and ECB forecasting failures, few amendments were made to the previous strategy statement published four years ago when persistent sub-target inflation and ultra-low rates were the principal concern. Predictably, the ECB's symmetric 2% inflation target was left unchanged as was the ECB's policy toolkit and its insistence that interest rates represent the preferred monetary policy instrument. And the Governing Council reserved the right to develop new tools to deal with unforeseen challenges if they might emerge. But while there was no explicit suggestion that the bar for launching QE in future might be significantly higher in future, we suspect that 'comprehensive proportionality' assessments might at some point inhibit recourse to such a tool. Meanwhile, given recognition of greater two-sided risks to the inflation outlook, and the likelihood that the euro area economy might from now on be subjected to larger and more frequent shocks than in the past, policymakers amended their strategy to emphasise the importance of 'appropriately forceful or persistent monetary policy action in response to large, sustained deviations of inflation from the

Italy: Harmonised CPI inflation contributions



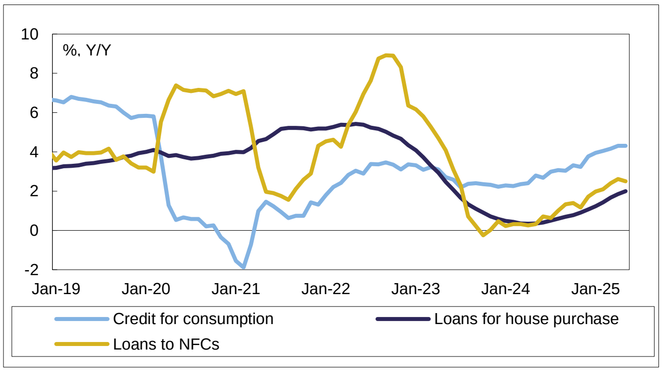
*Non-energy industrial goods.
Source ISTAT, Macrobond and Daiwa Capital Markets Europe Ltd.

Germany: Retail sales volumes*



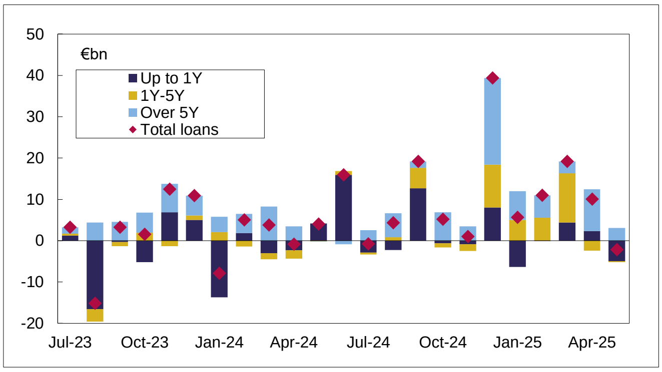
*Dashed lines show quarterly averages.
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Bank lending growth



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Business loan flows by maturity



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

target in either direction'. To some extent, that simply paid lip-service to the ECB's recent tightening cycle, when policy was aggressively (albeit belatedly) tightened in response to the series of significant upside inflation surprises. But the overall tone of the strategy review, and its emphasis on the increase in uncertainty and risks to the inflation outlook, underscored the sense that the Governing Council will be more hesitant to ease policy any further this cycle, unless the economic data strongly demand it.

The day ahead in the euro area

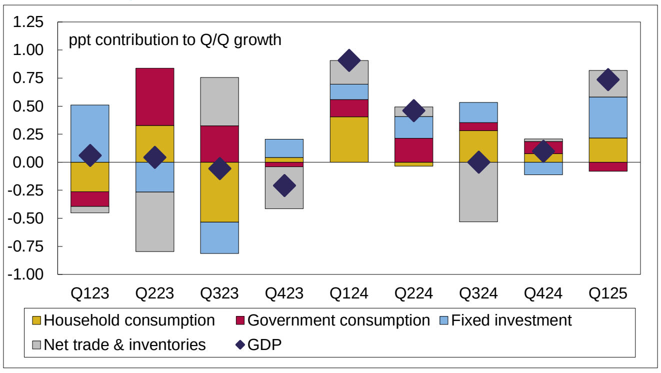
While the upside surprises in last week's French and Spanish inflation data present a risk to our forecasts for euro area inflation in June, today's releases would suggest that Tuesday's data will still be relatively soft. Indeed, we still merely expect a sidestep in headline HICP inflation (1.9%Y/Y), with ongoing services disinflation helping to offset the pickup in energy prices in the latter half of that month. It follows that core inflation may be a touch softer – we think by 0.1ppt, for a potentially 45-month low of 2.2%Y/Y – with inflationary pressures in core goods still largely absent. Decelerating wage growth as labour market dynamics have cooled has continued to underpin the ongoing moderation in services inflation. Of course, this process has progressed despite steady gains in employment and a historically low unemployment rate, chiefly thanks to job growth in peripheral member states associated with immigrant workers. Nonetheless, the jobless claims rate in Germany rose to almost a 4½-year high in May, with June's data expected to flag further loosening there at the start of the summer. Meanwhile, the final euro area manufacturing PMIs will be expected to align with the flash release and suggest a fourth-consecutive month of output expansion. And aside from the economic data, focus will also be on Sintra where ECB President Lagarde is due to appear on a panel discussion alongside Fed Chair Powell, BoE Governor Bailey and BoJ Governor Ueda – all the big monetary policy guns at once!

UK

Q1 GDP growth unrevised at 0.7%Q/Q, but household consumption supported by declining savings

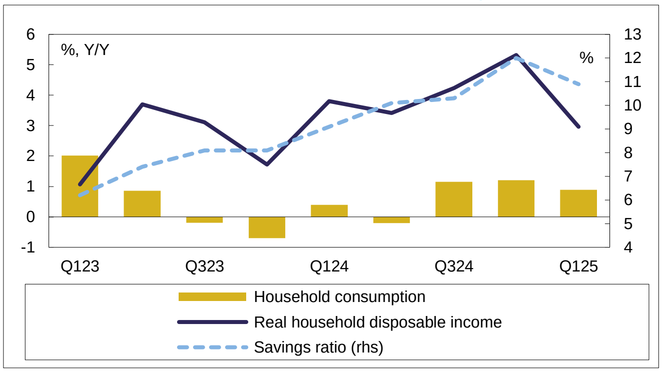
Today's updated national accounts confirmed that UK GDP accelerated in Q1 by 0.7%Q/Q, the most in a year and the fastest rate of all G7 economies. This left year-on-year growth unrevised at 1.3%Y/Y, and the level of output some 4.2% above the pre-pandemic benchmark in Q419. Like in the euro area, the front-running of US tariffs played a significant role in the first quarter, with exports up a chunky 3.3%Q/Q thanks to a surge in goods shipments to the US. But the contribution to GDP growth from net trade (0.3ppt) was reduced by solid import growth due to broad-based growth in private domestic demand. Indeed, despite being downwardly revised from the initial estimate, business investment jumped almost 4.0%Q/Q in

UK: GDP growth & expenditure contributions



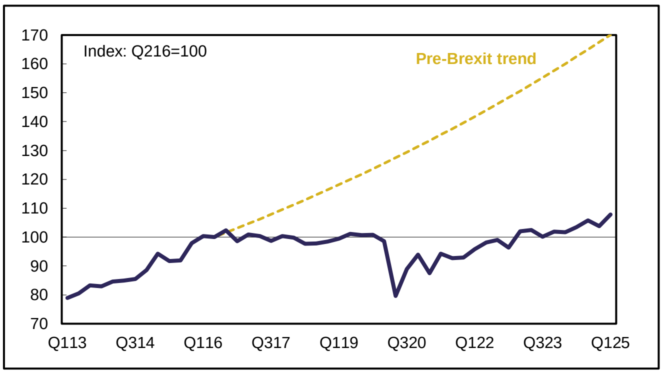
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Household consumption & savings ratio



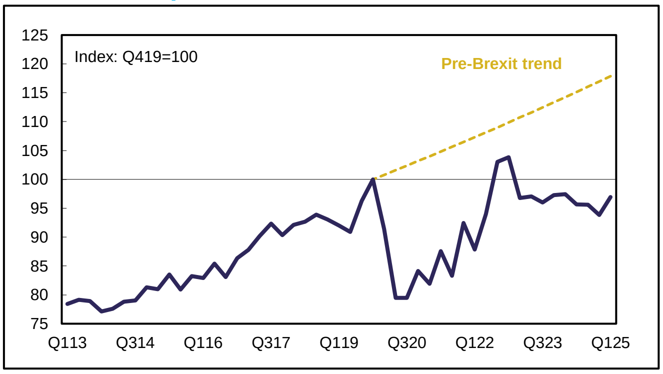
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: GDP - business investment



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: GDP - export volumes



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

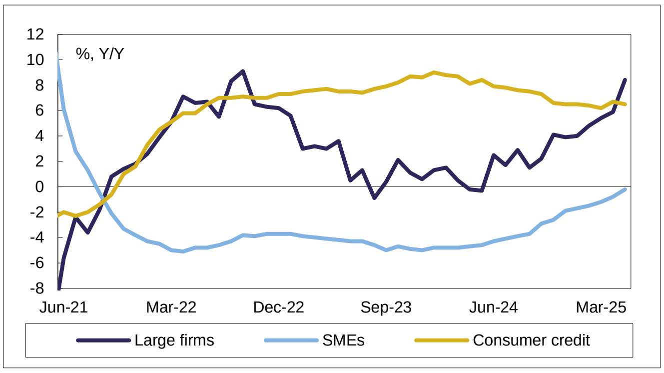
Q1, with total fixed investment (2.0%Q/Q) the strongest in two years to add a sizeable 0.4ppt to GDP growth. Today's release also suggested that household consumption was 0.2ppt firmer than initially estimated in Q1 at 0.4%Q/Q. With real disposable income having declined for the first quarter in eight (-0.9%Q/Q), household spending was supported by the first fall in two years in the savings ratio (down 1.1ppt to 10.9%). Admittedly, on a year-on-year basis, household real disposable income was still up 3.0%Y/Y, above the long-run average. And despite slipping back in Q1, the household savings ratio was still the second highest since Q221, suggesting scope for further declines to provide support to spending over coming quarters as long as the labour market does not soften too much.

Lending to businesses & households picks up in May

Today's monetary figures suggested that growth in household deposits slowed slightly further in May, to a nine-month low (4.7%Y/Y), with the average monthly increase so far in Q2 roughly half that in Q1. We would hesitate to suggest, however, that implies a further drop in the savings ratio this quarter. Indeed, consumer credit growth remained weak, with the monthly net increase (£0.9bn) down £1bn from April and the softest in 11 months. There was at least a modest recovery in mortgage lending that month, which rose a net £2.0bn following the net repayment of £0.8bn in April after the surge in completions in March ahead of the changes to stamp duty thresholds at the start of the fiscal year. There was also a pickup in mortgage approvals, by 2.4k to 63k, suggesting that – perhaps unsurprisingly – mortgage lending should accelerate gradually over coming months as the impact of the stamp duty distortion fades. This notwithstanding, net mortgage lending will remain significantly weaker than in Q1. As such, legal services relating to residential transactions – as illustrated in April's monthly GDP data – are bound to be a non-negligible drag on growth in Q2. And while the effective interest rate on new mortgages edged down slightly in May (to 4.47%), we note that the average rate on the outstanding stock of mortgages rose (to 3.86%) as houseowners remortgaged at slightly higher rates than expiring fixes.

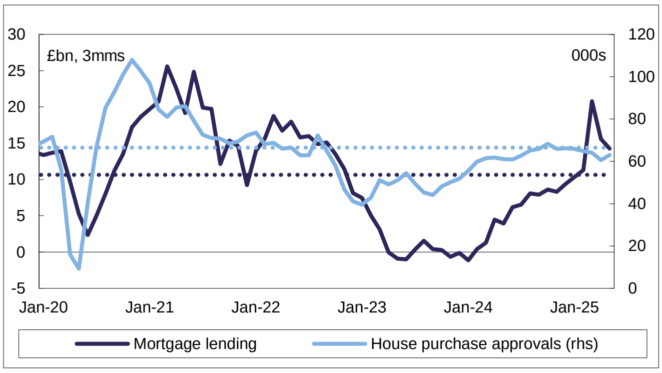
Beyond the household sector, and unlike in the euro area, there was a notable pickup in bank lending to businesses in May, to a net £8.6bn, the most in five years. Lending to large firms rose 8.4%Y/Y, the fastest rate since September 2022, with the pace of decline in lending to SMEs moderating further to -0.4%Y/Y. Encouragingly too, the effective interest rate on new loans from banks to UK non-financial firms moderated by almost 80bps on the month, and 160bps from the peak, to 5.60% in May, suggesting that the BoE's rate cuts are feeding through more substantively to corporate borrowers.

UK: Business lending and consumer credit growth



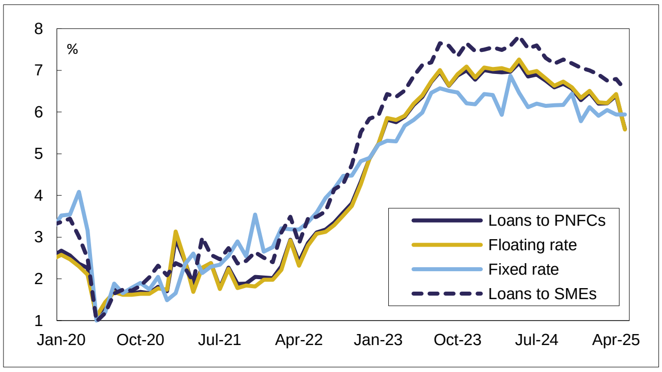
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Mortgage lending and approvals*



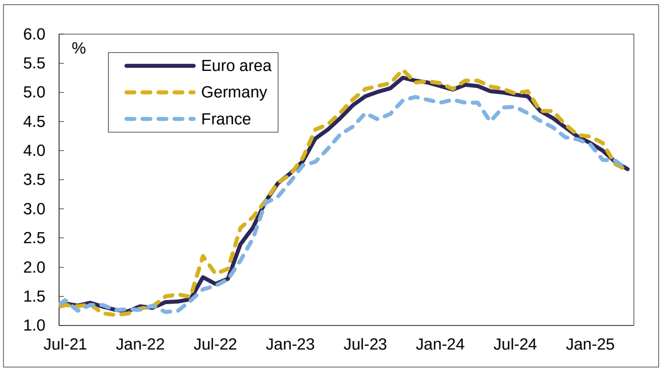
**Dotted lines show pre-pandemic 5Y average.*
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Average interest rate on new business loans



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Effective rate on new business loans



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

The day ahead in the UK

As well as BoE Governor Bailey's participation in Sintra, Tuesday will bring a handful of UK economic data releases. In particular, the BRC's shop price index will provide a preview as June's price developments in food and select goods categories. June's final manufacturing PMIs should hint towards a modest improvement in prospects at the end of Q2. While the flash PMIs indicated that manufacturing output remained in contractionary territory (47.1), that also marked a four-month high, while new orders (48.7) and backlogs (43.6) reportedly fell at their slowest pace in nine months. Nationwide data will also give an indication of house price growth in June.

European calendar

Today's results

Economic data

Country	Release	Period	Actual	Market consensus/ *Daiwa forecast*	Previous	Revised
Euro Area	M3 money supply Y/Y%	May	**3.9**	4.0	3.9	-
Germany	Preliminary HICP (CPI) Y/Y%	Jun	**2.0 (2.0)**	2.2 (2.2)	2.1 (2.1)	-
	Retail sales M/M% (Y/Y%)	May	**-1.6 (3.6)**	0.5 (3.6)	-1.1 (4.4)	-0.6 (4.6)
Italy	Preliminary HICP (CPI) Y/Y%	Jun	**1.7 (1.7)**	1.8 (1.7)	1.7 (1.6)	-
UK	GDP – final estimate Q/Q% (Y/Y%)	Q1	**0.7 (1.3)**	*0.7 (1.3)*	0.1 (1.5)	-
	GDP – private consumption Q/Q%	Q1	**0.4**	*0.2*	0.1	-
	GDP – government spending Q/Q%	Q1	**-0.4**	*-0.5*	0.5	-
	GDP – fixed investment Q/Q%	Q1	**2.0**	*2.9*	-0.6	-
	Current account balance £bn	Q1	**-23.5**	-20.3	-21.0	-
	Net consumer credit £bn (Y/Y%)	May	**0.9 (6.5)**	1.1 (-)	1.6 (6.7)	1.9 (-)
	Net mortgage lending £bn (mortgage approvals 000s)	May	**2.1 (63.0)**	2.5 (60.8)	-0.8 (60.5)	- (60.7)
	Lloyd's business barometer (own price expectations)	Jun	**51 (61)**	-	50 (63)	-

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/ *Daiwa forecast*	Previous
Euro Area	09.00	Final manufacturing PMI	Jun	*49.4*	49.4
	09.00	ECB consumer expectations survey – 1Y (3Y) CPI Y/Y%	May	-	3.1 (2.5)
	10.00	Preliminary headline (core) HICP Y/Y%	Jun	*1.9 (2.2)*	1.9 (2.3)
Germany	08.55	Final manufacturing PMI	Jun	*49.0*	48.3
	08.55	Unemployment claims rate % (change 000s)	Jun	6.4 (16.5)	6.3 (34)
France	08.50	Final manufacturing PMI	Jun	*47.8*	49.8
Italy	08.45	Manufacturing PMI	Jun	49.5	49.2
Spain	08.15	Manufacturing PMI	Jun	50.5	50.5
UK	00.01	BRC shop price index Y/Y%	Jun	0.2	-0.1
	07.00	Nationwide house price index M/M% (Y/Y%)	Jun	-0.1 (3.1)	0.5 (3.5)
	09.30	Final manufacturing PMI	Jun	*47.7*	46.4

Auctions and events

Country	BST	Event
Euro Area/UK	14.30	ECB President Lagarde, BoE Governor Bailey, Fed Chair Powell & BoJ Governor Ueda participate in policy panel in Sintra
UK	10.00	Auction: to sell £2bn of 1.5% 2053 green bonds

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Access our research blog at:
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