Daiwa Capital Markets

Euro wrap-up

Overview

- While the account of the ECB June policy meeting showed that a few Governing Council members would have been content not to have cut rates, Bunds followed Gilts higher.
- Despite a sizeable upwards revision to the UK PMIs and a sell-off in USTs, Gilts partly reversed Wednesday's losses after Prime Minister Starmer reaffirmed his support for Chancellor Reeves.
- Friday will bring May data for German factory orders, French & Spanish IP and June's construction PMIs for the euro area and UK.

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Daily bond market movements

Bond	Yield	Change
BKO 1.7 06/27	1.831	-0.024
OBL 2.4 04/30	2.143	-0.038
DBR 2.6 08/35	2.615	-0.039
UKT 3¾ 03/27	3.831	-0.040
UKT 4⅜ 03/30	3.982	-0.055
UKT 4½ 03/35	4.545	-0.065

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

Euro area

Final PMIs pushed marginally higher in further sign of stabilisation in economic conditions

Despite persisting uncertainties surrounding US trade policies, the final June euro area PMIs brought a modest upwards revision from the flash release, suggesting a further stabilisation in economic conditions at the end of Q2. In particular, the euro area's composite output PMI was upwardly revised by 0.4pt to 50.6 in June, a three-month high, to leave the quarterly index (50.4) bang in line with Q1. Admittedly, like other sentiment surveys, the PMIs were a poor guide to first-quarter GDP, failing to capture the surge in growth from substantive front-running of output and exports in certain industries ahead of the introduction of higher US tariffs in April. So, despite the sideways move in the activity PMI over the quarter, we certainly expect GDP growth to slow sharply from 0.6%Q/Q in Q1, if only as payback for such tariff-related anomalies. Today's survey, nevertheless, reinforced our view that growth remained modestly positive last quarter (0.1%Q/Q). And with the new orders index having risen to a 13-month high, firms were the most upbeat about the outlook for the year ahead since last July.

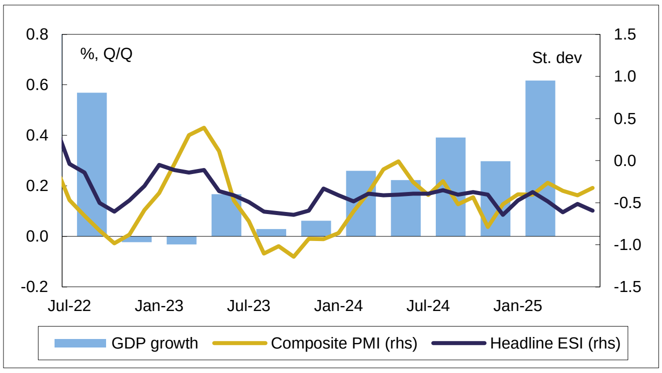
French services PMI led revision, but still implies the weakest performance of member states

The PMIs suggest that manufacturers remain relatively upbeat about production, with the respective index (50.8) consistent with ongoing expansion as firms in some subsectors were likely mindful of the 9 July deadline in the pause on Trump's 'reciprocal' tariffs. New orders growth was reportedly also the strongest for more than three years. The services activity index was also nudged higher from the flash to a modestly expansionary 50.5, the highest reading for three months. As has been the case in the previous four months, the upwards revision to the services index was led by France. But this still left the French composite index in contractionary territory (49.2) and the lowest of the surveyed member states. In contrast, the German composite PMI (50.4) rose to a three-month high and pointed to modest expansion. The Italian index (51.1) slipped back to a three-month low, though it too implied ongoing moderate growth. And while the Spanish PMI (52.2) was down more than 2pts from the average in Q1, it continued to point to outperformance among the member states.

Euro area unemployment ticks slightly higher, despite further drop in Spain and Greece

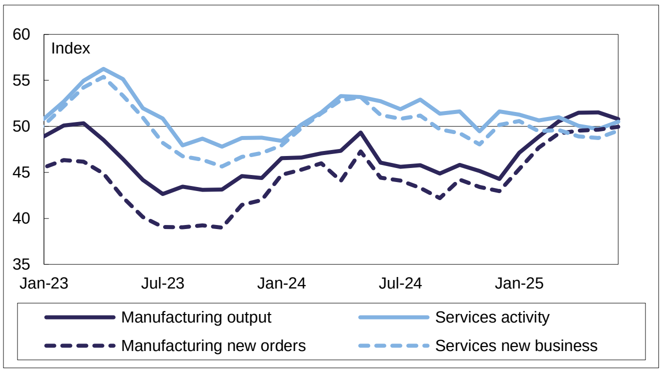
Given significant economic uncertainties, surveys unsurprisingly suggest that many firms currently have no intention to recruit. In this respect, today's composite employment PMI maintained the broadly sideways trend of the past four months at a broadly neutral 50.3. This follows an increase in joblessness in May, by 54k to 10.83mn, which pushed the euro area unemployment rate up 0.1ppt from the series low to 6.3%. The detail suggested that the uptick largely related to Italy, where the jobless rate jumped 0.4ppt to an 11-month high (6.5%). In contrast, the German (3.7%) and French ILO unemployment rates (7.1%) held steady, with the latter the lowest in more than two years. And the respective rates in Spain (10.8%) and

Euro area: GDP growth & survey indices



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

Euro area: Manufacturing & services PMIs



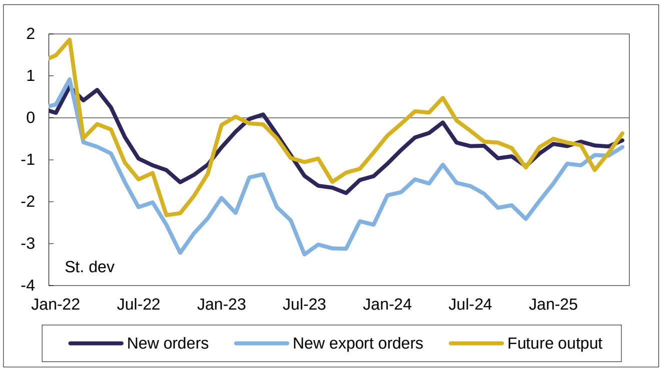
Source: S&P Global, Macrobond and Daiwa Capital Markets Europe Ltd.

Greece (7.9%) matched the lowest levels since 2008. While national figures suggest that we should expect a further drop in unemployment in Spain in June, there appears to remain ample labour slack. Moreover, the further downtrend in job vacancies and rise in jobless claims in Germany was maintained last month, suggesting that the labour market in the euro area's largest member state is becoming steadily less tight. Indeed, we expect the unemployment rate in Germany and the euro area as a whole to edge slightly higher in due course, supporting the ongoing slowdown in pay growth back to rates consistent with sustaining inflation at target over the medium term.

The day ahead in the euro area

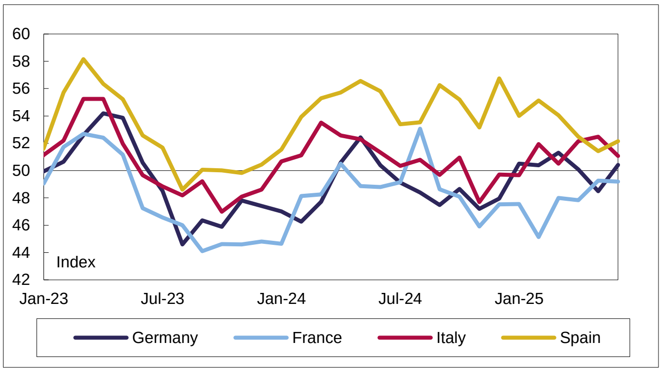
Friday's focus will be the first round of hard euro area activity data for May. In particular, German manufacturing new orders will be closely watched ahead of next Monday's IP release. Despite elevated trade uncertainty, orders advanced 0.6%M/M in April. And with the manufacturing PMIs continuing to point towards an expansion in demand in May (51.5) – albeit at a slower rate than in April (52.3), or more recently in June (52.6) – a third consecutive monthly increase in orders, for the first time since January 2022, remains a firm possibility. We also expect French and Spanish industrial output to rebound in May following declines of 1.4%M/M and 0.8%M/M respectively in April. Meanwhile, signs of underlying cost pressures in May's euro area PPI are likely to remain largely absent, with lower energy prices and euro appreciation expected to dampen the

Euro area: Selected composite PMIs



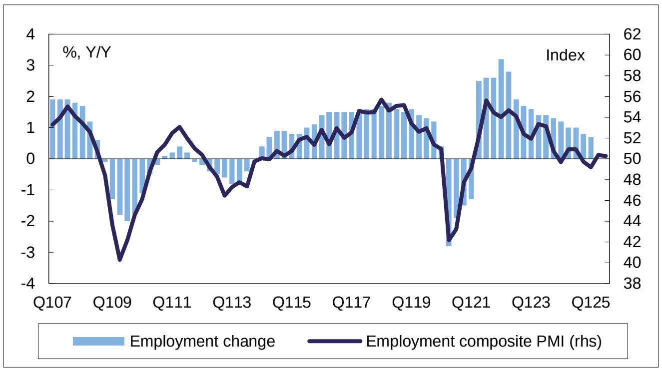
Source: S&P Global, Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area member states: Composite output PMIs



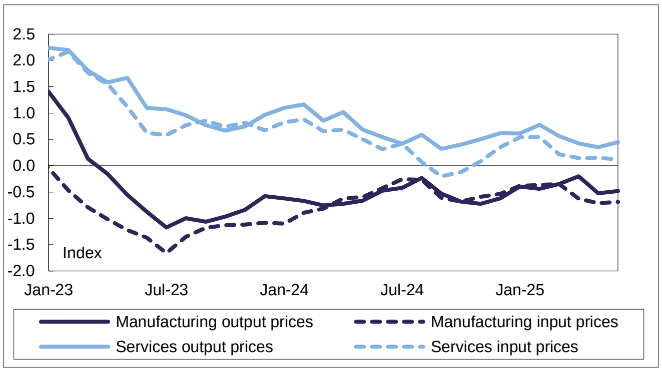
Source: S&P Global, Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Employment growth & PMI



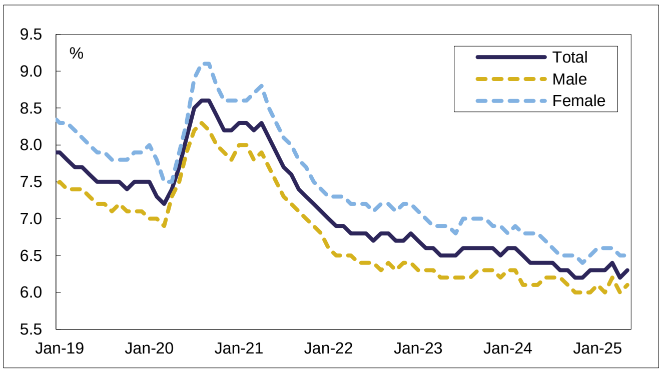
Source: S&P Global, Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Price PMIs



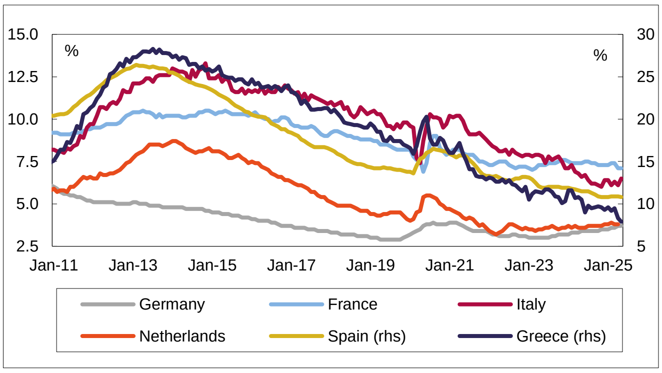
Source: S&P Global, Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Unemployment rate



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area member states: Unemployment rates



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

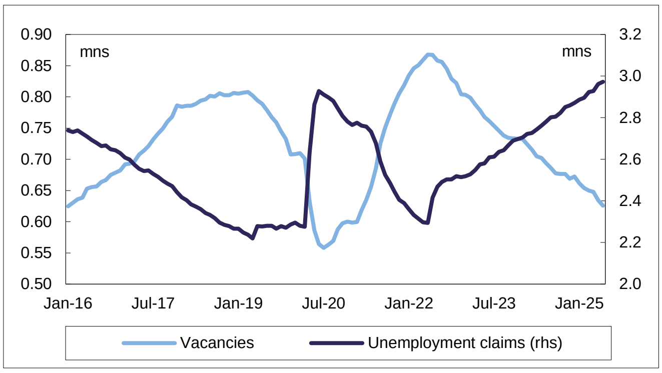
headline print further. The full set of June's euro area PMIs for the construction sector is also due on Friday, while Italian retail sales figures for May will provide a more complete picture of spending on the euro area high street ahead next Monday's aggregate euro area release.

UK

Gilts initially reverse Wednesday pm losses, as (even) higher taxes are likely to come in the autumn

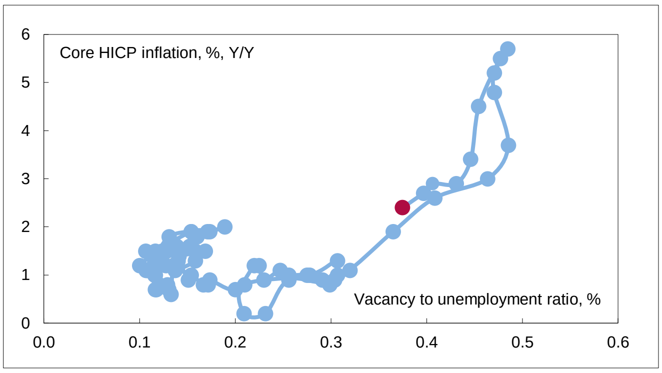
With PM Starmer having last night backed Chancellor Reeves to be in post 'for a very long time to come', Gilts rallied this morning until the release of the solid US labour market pushed global yields higher. Indeed, Gilts initially reversed most of their losses made yesterday afternoon when Starmer had appeared less sure about Reeves' future. So, to her political advantage, the market appears to view Reeves as a key guardrail between fiscal consolidation and irresponsibility. Certainly, while the tax burden already increased significantly in April, we expect her autumn budget to make further policy adjustments to try to ensure that public borrowing falls steadily as a share of GDP over the coming three years. But given the evidently huge political challenge making any substantive cuts to public expenditure – whether on welfare or other policy areas – those

Germany: Job vacancies & unemployment claims



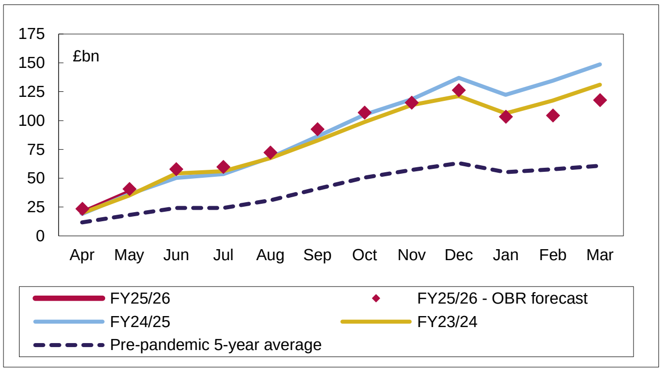
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Phillips curve*



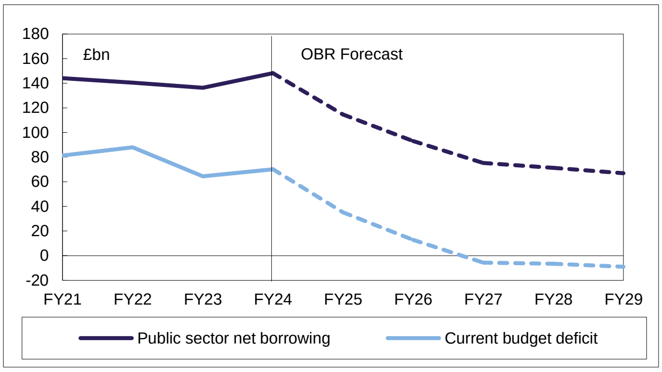
**Red dot represents latest figure for Q125.*
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Public sector net borrowing*



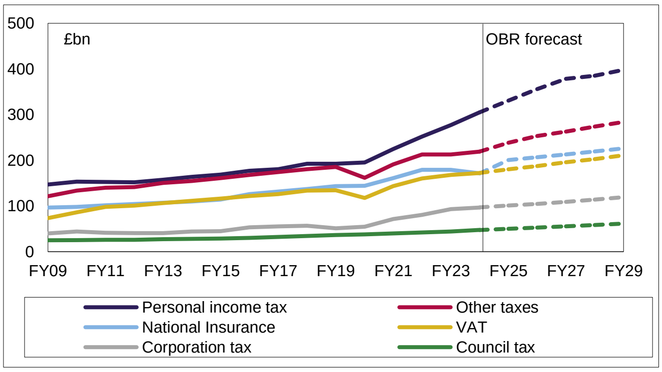
**Excluding financial interventions.*
Source: ONS, OBR, Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Net borrowing & current budget deficit xxx



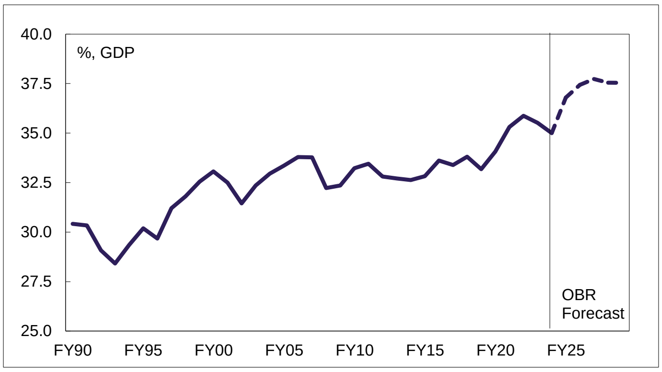
Source: OBR, Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Tax receipts



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

UK: National account taxes



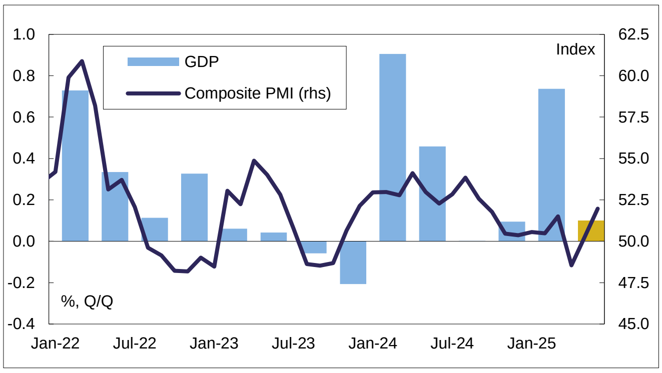
Source: OBR and Daiwa Capital Markets Europe Ltd.

adjustments will almost certainly take place on the revenue side. This week's U-turn on disability benefits reform leaves a hole of only about £5bn (about 0.2% of GDP) in the fiscal arithmetic. But the previous U-turn on pensioners' winter fuel payments will cost more than £1bn while higher gilt yields than had been expected by the OBR will also add to expenditure. And with only about £10bn initial headroom, and the OBR also likely to revise down its overly sanguine forecast assumptions on labour productivity and immigration and hence potential GDP growth, Reeves might well have to raise taxes by more than ½% of GDP to remain on track to meet her binding fiscal rule to balance the current budget by FY29/30. Savings and pensions appear among the more likely targets for a tax raid as do income tax thresholds. But, if the fiscal rules remain as currently specified so to avoid further upsetting the gilt market, we do not rule out Reeves and Starmer breaking the manifesto commitment not to raise the top rate of income tax or adding to the tax burden on the corporate sector. And, overall, taxes as a share of GDP seem highly likely to rise above the path projected by the OBR in March to hit a new series high by the end of the parliament.

Final services PMI revised up to a 10-month high, but firms signal ongoing cuts to headcount

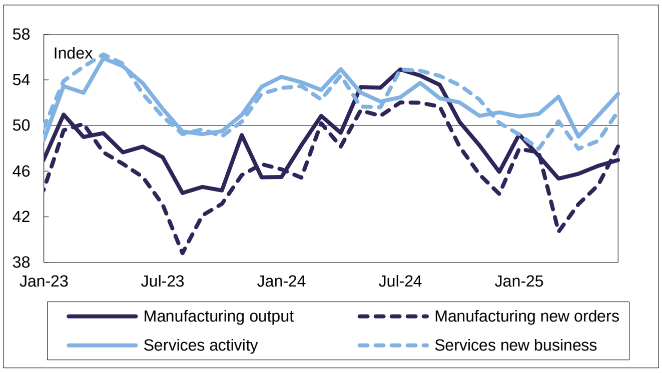
Today's final UK services PMIs provided a timely good-news story for the UK, pointing to an acceleration of growth momentum at the end of Q2, with demand at least in part likely buoyed by warm weather. In particular, the services activity index was revised a chunky 1.5pts higher from the flash release to 52.8, almost 4pts above April's trough and the highest since last August. And the new business component jumped 2.6pts on the month – the most in 11 months – to 51.3, the highest since November, supported by firmer domestic demand. This helped to counter reports of a further contraction in manufacturing output (47.0), although this encouragingly implied the softest pace of decline since February. As such, the composite output PMI was revised up from the flash estimate by 1.3pts to 52.0, the highest since September. Moreover, the new orders component (50.8) implied positive growth in demand for the first time since November. Over the second quarter as a whole, the composite PMI (50.3) averaged 0.6pt below the Q1 figure, suggesting an unsurprising slowdown in GDP growth from 0.7%Q/Q last quarter. And today's survey also suggested that businesses were a touch less upbeat about the outlook for the coming 12 months. As a result, the employment PMI (46.6) suggested that firms continued to cut headcount for a ninth consecutive month, providing further evidence of the ongoing weakening of the labour market that will surely trigger another cut to Bank Rate in August.

UK: GDP growth & composite PMI*



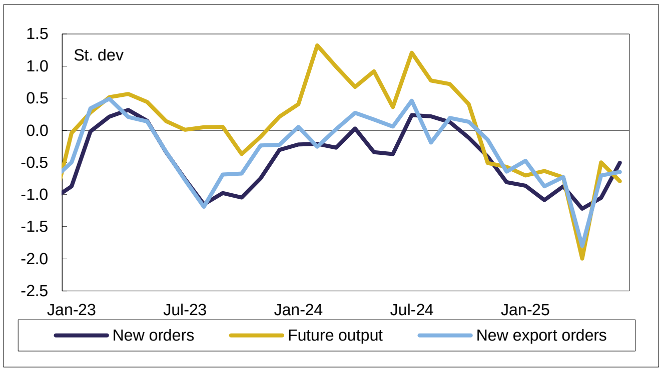
*Gold bar represents Daiwa GDP forecast for Q225
Source: S&P Global, Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Manufacturing & services PMI



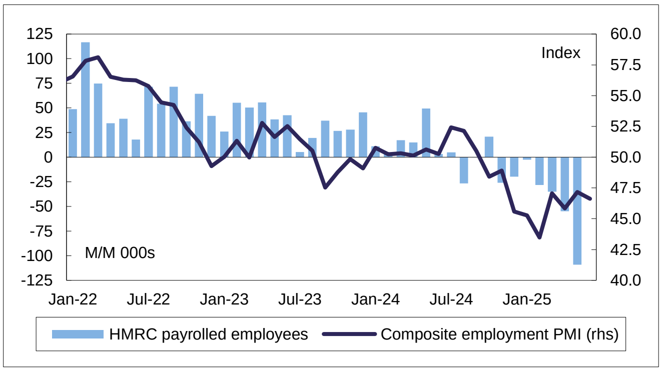
Source: S&P Global, Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Selected composite PMIs



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

UK: Payrolled employees & employment PMI



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

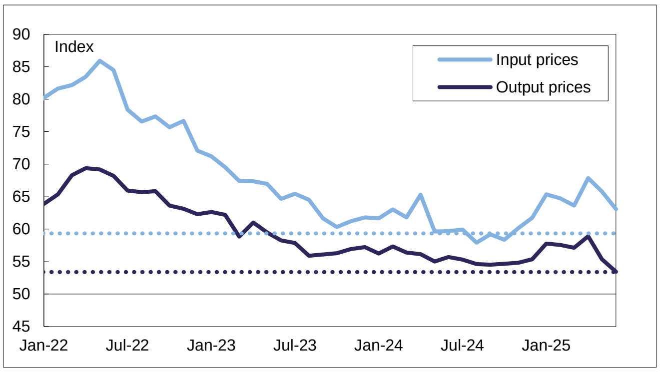
Survey price and wage indicators continue to suggest gradual moderation in inflation pressure

Beyond the activity indices, June's final PMIs reaffirmed the signal from the flash estimates of a welcome softening in price pressures. Admittedly, the composite input prices PMI remained elevated but nonetheless eased to a six-month low (63.1) despite last month's oil and petrol price rises. But, indicative of the weak demand environment, output prices reportedly rose at their slowest pace since February 2021 (53.4), down 2pts from May and a cumulative 5.5pt from April. Price pressures eased in both major sectors but owed primarily to falling output price inflation in services, for which the PMI fell a further 2.2pts to be bang in line with the long-run average (52.9). With the MPC projecting inflation to only fall back to target around the end of 2026, signs of wage moderation from June's Decision Maker Panel survey were welcome. With sales growth expectations the weakest in almost five years, expected wage growth 12 months ahead fell on a three-month basis to the slowest in three years, down 0.3ppt from Q1 to 3.6%3M/Y. And output price expectations moderated on the quarter to the lowest since before October's budget (similarly 3.6%3M/Y). Meanwhile, broader CPI inflation expectations for the coming 12 months were steady on a three-month basis at 3.2%3M/Y, with three-years ahead inflation expectations steady at 2.8%3M/Y. So, the MPC should continue to judge that inflation expectations remain broadly well-anchored.

The day ahead in the UK

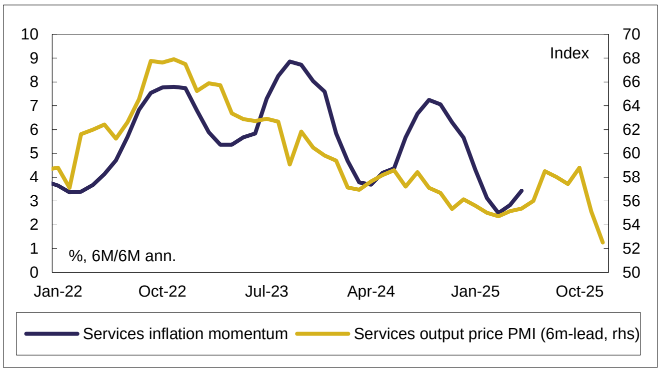
Having reported a modestly weaker contraction in May (up 1.3pts to 47.9), the UK construction PMI will provide an update on building activity in June. Elsewhere, BoE MPC external member Alan Taylor is due to give a speech on Friday evening on the topic of the equilibrium interest rate. His estimate of r* – restated yesterday to be around 2.75%-3.00% for the nominal rate – is among the more dovish on the MPC. Bank staff estimates for the figure range between 2.25-3.75%.

UK: Composite price PMIs*



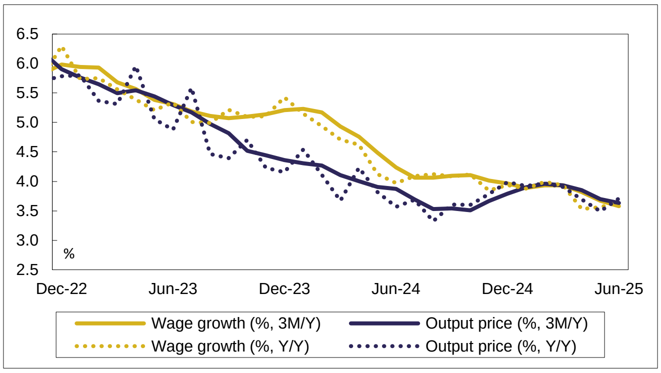
*Dotted lines represent long-run average.
Source: S&P Global, Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Services inflation momentum & output price PMI



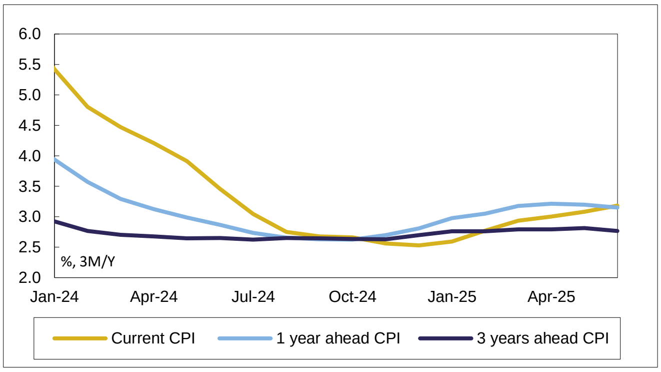
Source: S&P Global, Macrobond and Daiwa Capital Markets Europe Ltd.

UK: BoE DMP – Firms' wage & price expectations*



*12 months ahead.
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: BoE DMP – Firms' CPI inflation expectations



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Daiwa Capital Markets

European calendar

Today's results

Economic data

Country		Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Euro Area		Final composite (services) PMI	Jun	**50.6 (50.5)**	*50.2 (50.0)*	50.2 (49.7)	-
Germany		Final composite (services) PMI	Jun	**50.4 (49.7)**	*50.4 (49.4)*	48.5 (47.1)	-
France		Final composite (services) PMI	Jun	**49.2 (49.6)**	*48.5 (48.7)*	49.3 (48.9)	-
Italy		Composite (services) PMI	Jun	**51.1 (52.1)**	51.6 (52.9)	52.5 (53.2)	-
Spain		Composite (services) PMI	Jun	**52.1 (51.9)**	51.2 (51.0)	51.4 (51.3)	-
UK		DMP 3M output price (1Y CPI) expectations Y/Y%	Jun	**3.6 (3.3)**	3.5 (3.0)	3.7 (3.0)	-
		Final composite (services) PMI	Jun	**52.0 (52.8)**	*50.7 (51.3)*	50.3 (50.9)	-

Auctions

Country		Auction
France		sold €7.674bn of 3.2% 2035 bonds at an average yield of 3.27%
		sold €2.355bn of 3.6% 2042 bonds at an average yield of 3.72%
		sold €1.923bn of 3.75% 2056 bonds at an average yield of 4.05%
Spain		sold €735mn of 1.15% 2036 inflation-linked bonds at an average yield of 1.47%
		sold €2.159bn of 2.4% 2028 bonds at an average yield of 2.159%
		sold €2.132bn of 3.15% 2035 bonds at an average yield of 3.163%
		sold €1.758bn of 3.5% 2041 bonds at an average yield of 3.671%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

Country		BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Euro Area		08.30	Construction PMI	Jun	-	45.6
		10.00	PPI Y/Y%	May	0.3	0.7
Germany		07.00	Factory orders M/M% (Y/Y%)	May	-0.2 (5.7)	0.6 (4.8)
		08.30	Construction PMI	Jun	-	44.4
France		07.45	Industrial production M/M% (Y/Y%)	May	0.3 (-0.6)	-1.4 (-2.1)
		08.30	Construction PMI	Jun	-	43.1
Italy		08.30	Construction PMI	Jun	-	50.5
		09.00	Retail sales M/M% (Y/Y%)	May	-	0.7 (3.7)
Spain		08.00	Industrial production M/M% (Y/Y%)	May	0.5 (1.3)	-0.8 (0.6)
UK		09.00	New car registrations Y/Y%	Jun	-	1.6
		09.30	Construction PMI	Jun	48.5	47.9

Auctions and events

Country		BST	Event
Euro Area		13.15	BdF Governor & ECB Governing Council member Villeroy speaks on panel at Les Recontres Economiques, Aix-en-Provence
UK		18.30	BoE MPC external member Taylor to give speech on the natural rate of interest (published 16:00) at LSE, London.

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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