Euro wrap-up

Overview

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- Bunds followed USTs higher as euro area goods exports fell to a five-month low in May, signalling a likely negative contribution from net trade to Q2 GDP growth.
- Gilts made losses following an upside surprise to UK inflation in June.
- Thursday will bring the latest UK labour market report and final June estimates of euro area inflation, including the granular detail.

Daily bond market movements

Bond	Yield	Change
BKO 1.9 09/27	1.835	-0.041
OBL 2.2 10/30	2.221	-0.038
DBR 2.6 08/35	2.689	-0.020
UKT 3¾ 03/27	3.853	+0.029
UKT 4⅜ 03/30	4.045	+0.017
UKT 4½ 03/35	4.642	+0.020

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

Euro area

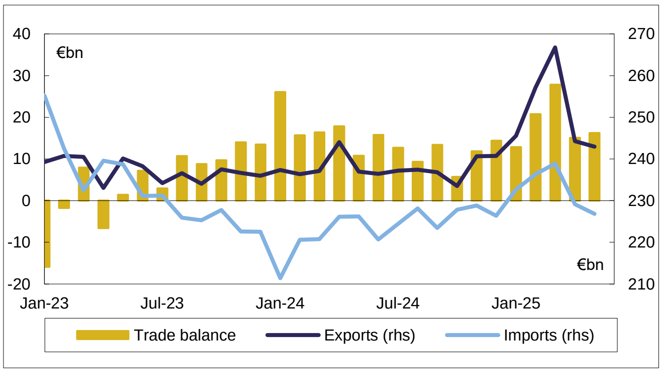
Despite widening in trade surplus in May, net trade likely to weigh on euro area GDP growth in Q2

The front-loading of US-bound shipments in the first quarter saw euro area export values surge 7.6%Q/Q, the most since the rebound after the first Covid-19 lockdown in 2020 and global financial crisis in 2010 before that. The hike in US tariffs in April inevitably resulted in a sharp correction in April (-8.4%M/M), which led to a near-halving of March's record trade surplus to €15.1bn. Today's goods trade release flagged a slight widening in May, to €16.2bn. Admittedly, that was attributable to a larger drop in import values (-1.0%M/M), while exports declined for a second successive month (-0.5%M/M). This still took the level of export values to a five-month low, to be trending in Q2 thus far some 5% below the Q1 average. This notwithstanding, exports to the UK and Japan reported a welcome recovery in May, rising to their highest levels since April 2024 (€25.1bn) and September 2022 (€5.8bn) respectively. And there were further signs that tariffs were continuing to influence 'traditional' flows to the US, with exports of chemical products to the US – notably inclusive of pharmaceutical goods – remaining elevated amid rumours about impending outsized sector-specific tariffs targeting the industry. Indeed, while still significantly below March's peak, exports of these goods to the US remained up 34%Y/Y in May. By comparison, however, exports of machinery and transport goods, the latter of which are already exposed to higher US levies, continued to edge lower, down 3.9%M/M and 13%Y/Y, to their lowest level since June 2022. The downtrend in euro area shipments to China was also maintained, with exports falling to the lowest level in five years. But while there had been expectations that higher US levies may prompt greater inflows of Chinese goods to Europe, these also fell back. Overall, although total import values were trending some 3½% below the Q1 average, it now seems highly probable that net trade subtracted from GDP growth in Q2, reversing part if not all the 0.3ppt contribution in Q1.

The day ahead in the euro area

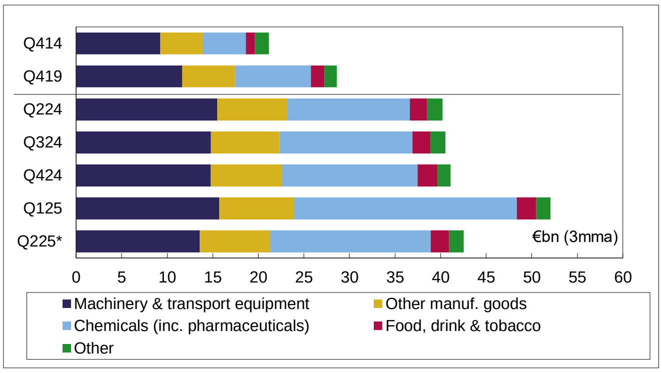
Like the French and Spanish figures, today's final estimate of Italian inflation revised up the HICP rate by 0.1ppt from its preliminary estimates to 1.8%Y/Y. To two decimal places those revisions were all relatively marginal, and as such tomorrow's final euro area inflation figures are still expected to align with the flash estimates that showed the headline HICP rate bang in line with the ECB's 2% target. A weaker drag from energy prices was the principal source of the modest uptick in headline inflation in June (0.1ppt). The granular detail in tomorrow's release should otherwise continue to signal that the services components remained broadly stable and consistent with an ongoing disinflation trend. As such, we also expect confirmation that core inflation moved sideways in June (2.3%Y/Y). And despite pressures elsewhere, courtesy of a sharp drop in food inflation in Germany, tomorrow's release should also confirm some stabilisation in that category having peaked in May at a 15-month high (3.2%Y/Y).

Euro area: Goods trade balance*



*Seasonally adjusted values.
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Goods export values by good-type



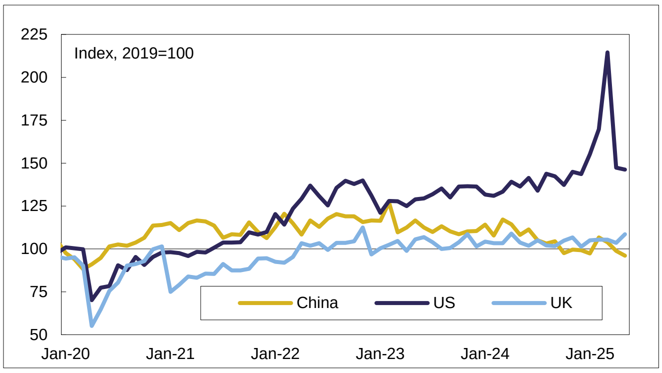
*Q225 based on April & May data.
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK

UK inflation surprised to the upside in June amid a rise in energy, food and core goods inflation

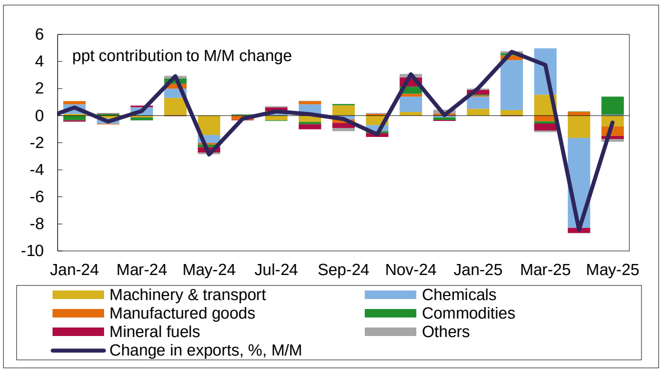
Against expectations for steady inflation in June, today's UK CPI report surprised to the upside, with the headline rate rising 0.2ppt to 3.6%Y/Y, the highest since January 2024. This pushed the average in Q2 up to 3.5%Y/Y, 0.7ppt higher than in Q1 and 0.1ppt above the BoE's projection. Admittedly, the uptick in June in part reflected higher motor fuel prices amid the temporary spike in the oil price that month. Indeed, this pushed energy inflation (-0.7%Y/Y) up 1ppt to a 21-month high, to account for roughly half of the 0.2ppt increase in CPI inflation. The more hawkish members of the MPC might be more concerned about potential second-round effects emanating from food inflation, which rose a further 0.2ppt to 4.4%Y/Y, a 16-month high and 1.0ppt above the BoE's projection, while alcohol inflation jumped 1.7ppts to an 11-month high (5.0%Y/Y). Within the core components, a fourth consecutive above-average increase in prices of non-energy industrial goods pushed the annual core goods rate up 0.2ppt to 1.8%Y/Y, the firmest since February 2024. So, while services inflation moved sideways at 4.7%Y/Y – a touch above the BoE expectation – core inflation rose 0.2ppt to 3.7%Y/Y (+0.12ppt to 3.66%Y/Y, to two decimal places).

Euro area: Goods export values by destination



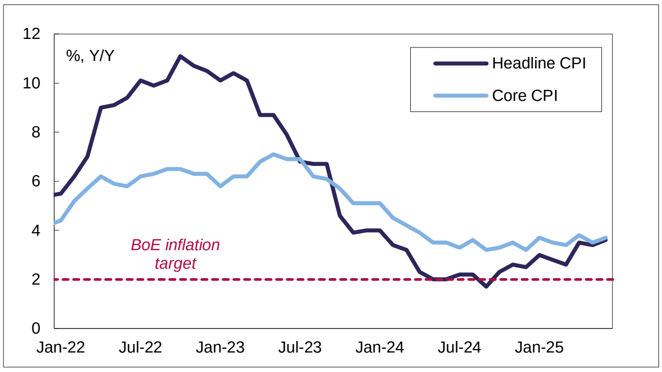
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Contributions to export growth



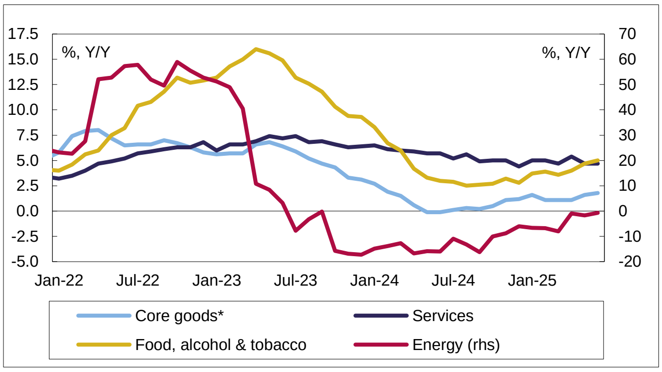
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Headline & core CPI inflation



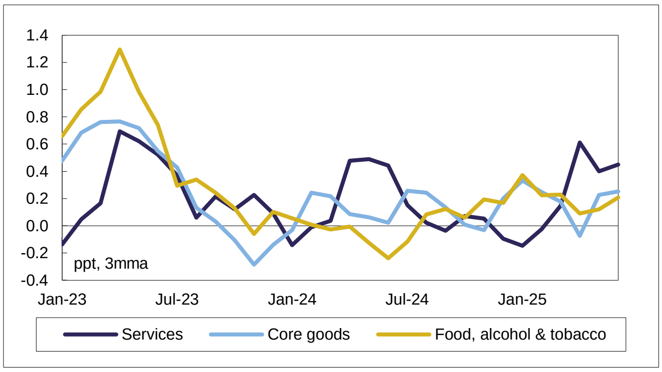
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Key CPI inflation components



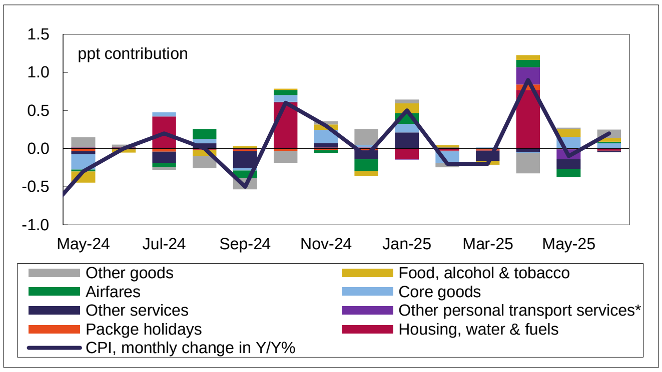
*Non-energy industrial goods.
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Deviations from long-run price change*



**Monthly change in prices compared with the average for the month in the decade before the pandemic. **Non-energy industrial goods.*
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Monthly change in annual CPI inflation



**Including Vehicle Excise Duty.*
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

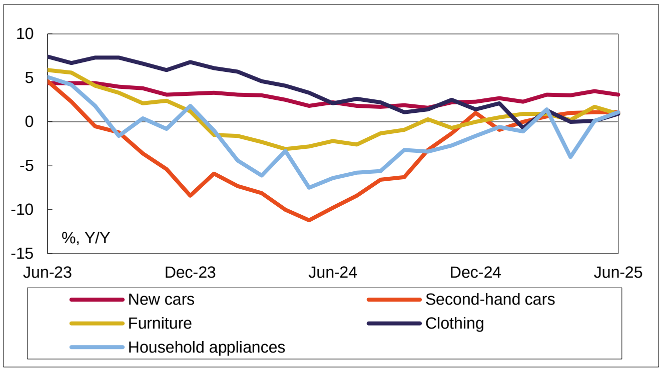
Upwards impulses relate in part to seasonal volatility

We caution that upwards impulses in the core components at end-Q2 appear to be partly related to seasonal volatility that should prove temporary. For example, clothing inflation returned to positive territory in June having been negative in the previous two months due in part to changing discounting periods. Prices of major household appliances (notably refrigerators) also jumped last month (6½%M/M) having declined a year ago. Meanwhile, transport services costs were boosted by the largest rise in air fares in any June since 2018, while rail fares also increased, particularly for international routes, compared with a decline in June last year. Admittedly, when excluding the more volatile items, underlying services inflation still edged slightly higher last month. But the measure of core services inflation watched by the BoE which excludes volatile and indexed components, at 4.3%Y/Y, was still the second-softest reading since the start of 2022 and more than 3ppts below the peak in early 2023.

BoE still expected to cut rates even as inflation is likely to peak at close to 4%Y/Y

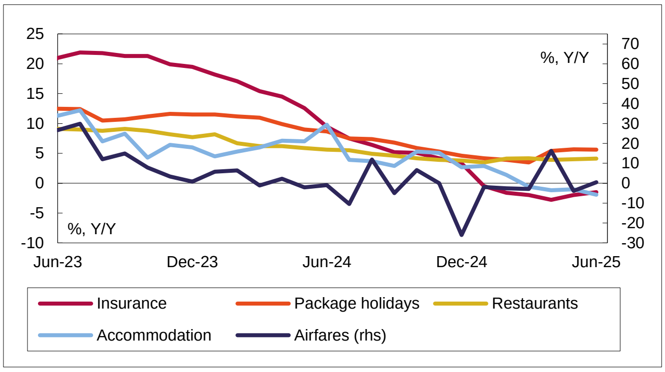
The UK's inflation outlook remains highly uncertain. While we expect price-setting to normalize over coming months, we forecast services inflation to move marginally higher due to unfavourable base effects before taking a step down next year. And notwithstanding the potential dampening impact of past sterling appreciation, core goods inflation is expected to move only slightly lower over the near term. As such, core inflation should remain broadly steady. Beyond that, and despite the near-7% cut in the regulated household energy price cap at the start of this month, we expect the energy component to rise steadily through to September due to less favourable base effects. And while food inflation might be at or near the peak, it is also likely to add around ¾ppt to headline inflation over the next six months. So, we expect headline inflation to rise further through to September, peaking close to 4%Y/Y, a touch firmer than previously projected by the BoE (3.7%Y/Y). Like the BoE, we expect inflation to ease gradually thereafter, which should justify a further rate cut next month. But the upside surprise to today's data also provides a reminder that that decision might not be unanimous, with the hawks on the Committee potentially wary of supporting a rate cut until the peak in inflation is firmly in the rear-view mirror. And while the recent weakening in the jobs market might have justified a tweak to the forward guidance to allow for a faster pace of rate cuts, today's data reinforce our view that the MPC will maintain that "a gradual and careful approach to the further withdrawal of monetary policy restraint remains appropriate", implying a continuation of the status quo for one 25bps cut a quarter this cycle.

UK: Selected goods CPI components



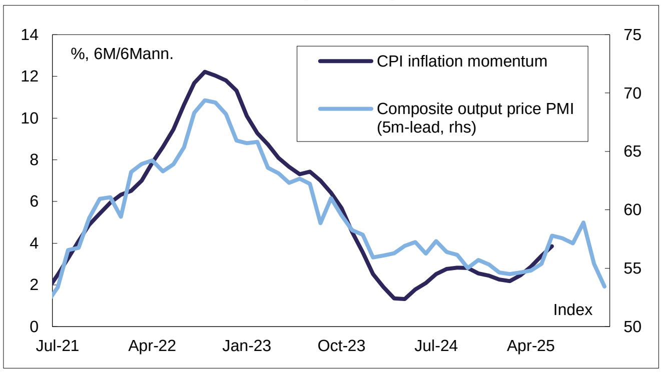
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Selected services CPI components



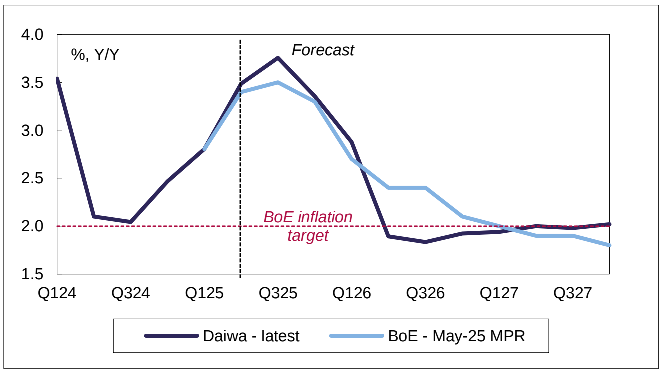
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: CPI inflation & composite price PMI



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

UK: CPI inflation forecast



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

The day ahead in the UK

Given the growing sensitivity of some on the MPC, including Governor Bailey, towards the recent signs of loosening in the jobs market, tomorrow's labour market report should provide greater reassurance that the BoE will continue to remove policy restrictiveness in August despite the upside to June's inflation print. Though often revised, May's report flagged a seventh consecutive month of net job losses for payrolled employees and at the fastest pace in the five years since the pandemic (-109k) to be cumulatively down 276k since October's budget. Vacancies too have extended their recent downtrend to below their pre-pandemic levels. And recent business surveys have continued to suggest that less tight conditions are steadily feeding into their wage-setting and price-setting dynamics. In that respect, and despite the ongoing scrutiny of the core labour force survey, private sector regular wage growth in April (5.1%3M/Y) were already undershooting the BoE's expectations for end-Q2 by 0.1ppt. That measure also seems likely to fall below 5%3M/Y in May for the first time since February 2022, with the Bloomberg market consensus currently predicting a 0.3ppt step-down to 4.8%3M/Y.

European calendar

Today's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Euro Area	Trade balance €bn	May	**16.2**	14.0	14.0	15.1
Italy	Final HICP (CPI) Y/Y%	Jun	**1.8 (1.7)**	*1.7 (1.7)*	1.7 (1.6)	-
UK	Headline (core) CPI Y/Y%	Jun	**3.6 (3.7)**	*3.4 (3.4)*	3.4 (3.5)	-
	House price index Y/Y%	May	**3.9**	-	3.5	3.6

Auctions

Country	Auction
Germany	sold €800m of 1.25% 2048 bonds at an average yield of 3.13%
	sold €1.129bn of 2.9% 2056 bonds at an average yield of 3.22%
UK	sold £1.5bn of 4.5% 2034 bonds at an average yield of 4.553%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

Country	BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
Euro Area	10.00	Final headline (core) HICP Y/Y%	Jun	*2.0 (2.3)*	1.9 (2.3)
UK	07.00	Average earnings (excluding bonuses) 3M/Y%	May	5.0 (4.9)	5.3 (5.2)
	07.00	Private sector regular wages 3M/Y%	May	4.8	5.1
	07.00	Unemployment rate 3M%	May	4.6	4.6
	07.00	Employment 3M/3M change 000s	May	46	89
	07.00	Payrolled employees M/M change 000s	Jun	-35	-109
	07.00	Claimant count rate % (change 000s)	Jun	-	4.5 (33.1)

Auctions and events

Country	BST	Event
France	09.50	Auction: to sell up to €12bn of 2.4% 2028, 2.5% 2030 & 2.7% 2031 bonds
	10.50	Auction: to sell up to €1.5bn of 0.6% 2034, 0.1% 2038 & 0.55% 2039 inflation-linked bonds
Spain	09.30	Auction: to sell 2.7% 2030, 3.2% 2035 & 2.7% 2048 bonds
UK	10.00	Auction: to sell £4.75bn of 4.375% 2030 bonds

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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