

Euro wrap-up

Overview

- Bunds followed the global trend lower, while an investor survey flagged ongoing challenges to Germany's near-term economic outlook.
- Gilts underperformed as markets reacted to increasing calls for UK PM Starmer to step down and the prospects of looser fiscal policy under his potential successors.
- Wednesday will bring updated estimates of euro area Q1 GDP and employment, as well as industrial production data for March.

Emily Nicol
+44 20 7597 8331

Edward Maling
+44 20 7597 8030

Daily bond market movements

Bond	Yield	Change
BKO 2½ 06/28	2.706	+0.066
OBL 2½ 04/31	2.812	+0.067
DBR 2.9 02/36	3.099	+0.061
UKT 4¾ 03/28	4.533	+0.075
UKT 4¾ 03/31	4.640	+0.095
UKT 4¾ 10/35	5.101	+0.104

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

Euro area

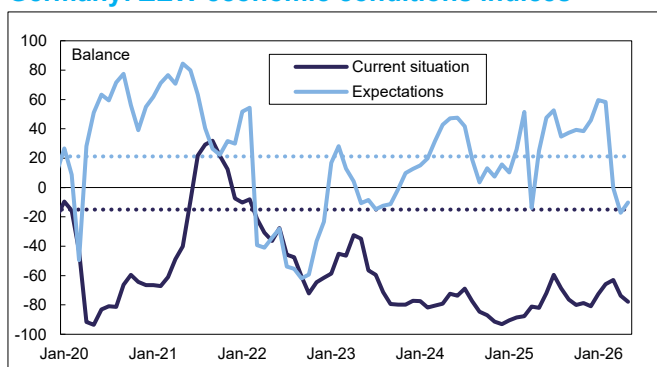
ZEW signals slight improvement in outlook, but investors still pessimistic about German economy

Today's ZEW survey sent mixed signals on investor perceptions of the German economy, but headlines focused on a modest improvement in the outlook on tentative hopes of an end to the war in the Middle East and a positive impact from government support measures. Indeed, the index of expectations for the coming six months rose 7pts in May to -10.2, with the share of respondents expecting conditions to remain broadly unchanged rising back close to 50%. But given still elevated oil prices, tightening supply bottlenecks and weakening demand, just one fifth expected conditions to 'improve' over the summer, matching the lowest such share in 2½ years and well below the average in the 12 months before the war. Furthermore, investors were still particularly downbeat about the current economic backdrop, with the respective survey index falling to a six-month low. More than three quarters of respondents judge conditions as 'bad', highlighting concerns that German GDP growth will slip back into negative territory in Q2 and possible technical recession over the summer. Moreover, inflation expectations remain elevated, with over 70% of respondents expecting inflation to rise over the coming six months. And almost two thirds of respondents – the most since mid-2023 – expect the ECB to tighten policy over coming months. With higher rates anticipated, investor perceptions of banks and insurers remained favourable this month, with the profit outlook for utilities and IT firms also viewed positively. However, constructors' balance sheets were expected to be hit by weak demand and higher borrowing costs. And high energy prices weighed even more heavily on the already downbeat assessment of the financial outlook for manufacturers of autos, chemicals and other heavy industrial sub-sectors.

German core goods inflation contained for now, but services inflation flattered by Easter timing

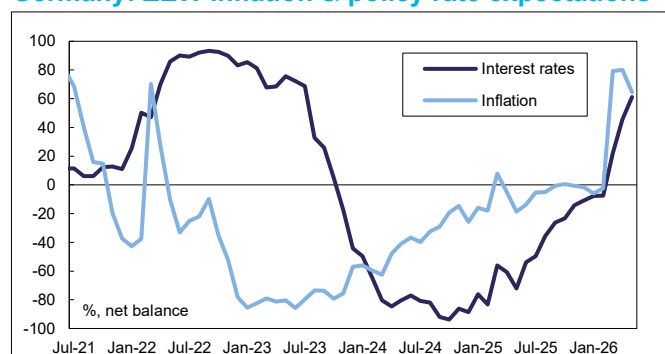
After the initial jump in German consumer inflation in March in response to the energy price shock, today's final April inflation estimates confirmed that the uptick that month was more modest, with the national and EU-harmonised rates rising just 0.1-0.2ppt to 2.9%Y/Y, nevertheless the highest for more than two years. As in March, the detail showed that energy remained the key source of pressure, with inflation of heating oil (27.8%Y/Y) and auto fuel (26.0%Y/Y) leaping to the highest rates since September 2022. In contrast, inflation of electricity and gas remained relatively well contained. And there was still little evidence of a broader pass-through to other goods and services. Food inflation rose only slightly to a three-month high (1.2%Y/Y). Meanwhile, core goods inflation appears to have moved broadly sideways, with an ongoing drag from household appliances and consumer electronics. And today's release confirmed that services inflation fell 0.4ppt to 2.8%Y/Y, the lowest since August 2022. Admittedly, this was flattered by the timing of Easter, with a marked drop in inflation of airfares and package holidays, down a chunky 23ppts and 8½ppts respectively. Looking ahead, fiscal measures will suppress German auto-fuel prices in May and June to subtract about ¼ppt from inflation. And while softer demand will limit firms' pricing powers to some extent, still elevated oil prices should eventually push core and food inflation higher over the summer.

Germany: ZEW economic conditions indices*



*Dotted lines represent long-run average. Expectations for coming six months.
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Germany: ZEW inflation & policy rate expectations*



*Coming six months. Source: Macrobond and Daiwa Capital Markets Europe Ltd.

The day ahead in the euro area

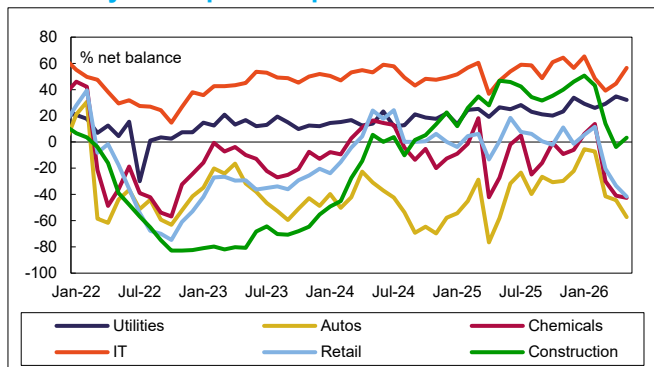
The second set of estimates for Q1 GDP growth – which will be accompanied by March IP data and preliminary estimates for employment growth – will provide the focal point for Wednesday's European dataflow. The [preliminary GDP](#) release showed growth slowing to just 0.1%Q/Q, the softest in three quarters and 0.2ppt below the ECB's forecasts in March. While affirming the signals of a likely-temporary boost to manufacturing activity in response to events in the Middle East, March's industrial production data also look primed to reinforce perceptions about a significant loss of growth momentum last quarter. Indeed, figures from the member states point towards a 0.5%M/M increase in euro area IP last month as solid gains across most key member states sufficiently offset weakness in Germany (-1.2%M/M). But that should still confirm a sharp pullback in IP across the whole quarter in the region of ¾-1%Q/Q. And while the close proximity of the flash GDP estimate to 0.2%Q/Q (0.148%Q/Q to 3 decimal places) means that an upwards revision to GDP cannot be completely ruled out, the pullback in retail sales volumes and from activity indicators more broadly means that we do not expect one. Releases from the member states, like GDP, also point towards a moderation in employment growth at the start of the year amid a fourth consecutive contraction in Germany and weaker impulse from Spain during the off-season. Inflation detail from France in April will provide further insights into the drivers of euro area inflation ahead of next week's final print.

UK

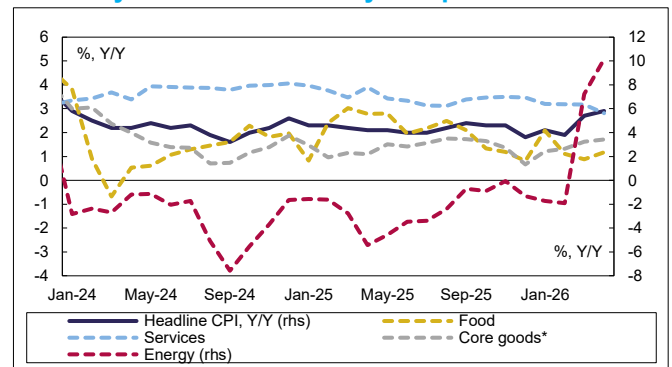
Gilt yields surge as PM Starmer faces increasing calls to step down

Last week's predictable results in elections in England, Scotland and Wales – which saw the Labour Party lose a significant number of seats and control of councils chiefly to the populist Reform and Green parties – has inevitably fuelled speculation that Prime Minister Starmer will face an imminent challenge to his leadership. His so-called 'reset' speech yesterday certainly did nothing to save him. And despite today's warning at his Cabinet meeting that efforts to oust him would be 'destabilising' for the UK, the resignation of some high-profile (albeit junior) ministers underlines the scale of the challenge he faces to remain in office. Reports suggest that more than 81 MPs want Starmer to step down, enough to meet the 20% threshold needed to trigger a leadership contest if they all backed the same candidate. But there still appears to be no clear consensus around who the challenger should be, suggesting that Starmer could limp on until the Autumn. The market reaction over recent days – with long-dated Gilt yields having surged to the highest level since 1998 – suggests that investors have a strong preference to maintain the status quo in Downing Street. But while more than 100 MPs signed a statement giving Starmer his backing, on balance we think that his days as PM are likely numbered. An early leadership contest before the

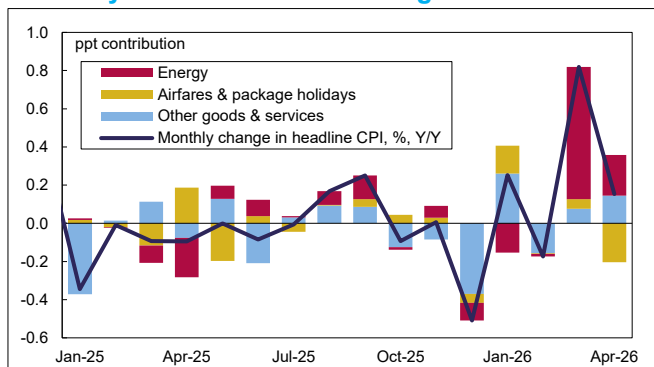
Germany: ZEW profit expectations*



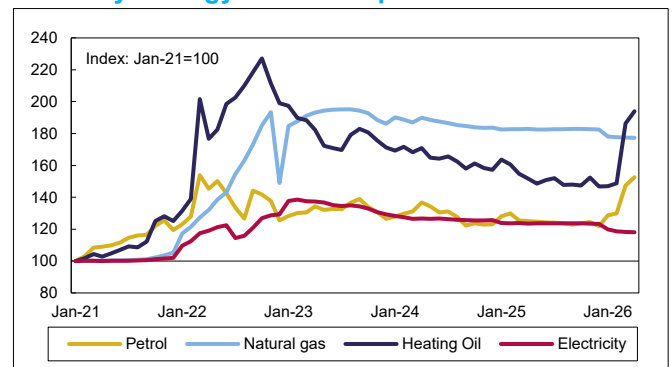
Germany: CPI inflation & key components



Germany: Contributions to change in inflation



Germany: Energy consumer price levels



summer would seemingly favour current Health Secretary Streeting. Assuming (perhaps bravely in current circumstances) that he might subsequently win a by-election to regain a seat in Parliament, a later contest might favour Manchester Mayor Andy Burnham. But we certainly can't rule out an alternative candidate altogether. And the risk that the UK might have its sixth Prime Minister since 2019, with relatively unknown economic policy preferences and political weakness leaving them hostage to their backbench MPs, unsurprisingly gives investors cause for unease.

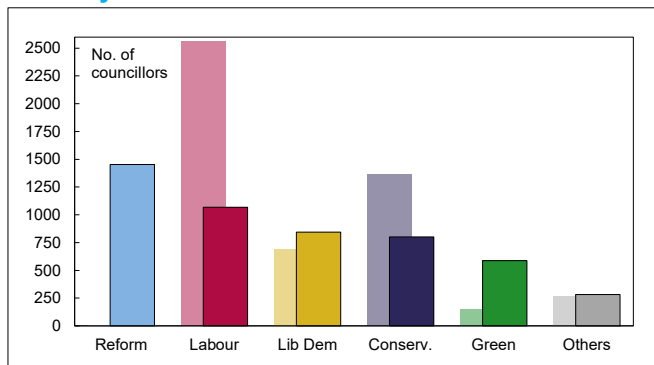
Fiscal trajectory under Starmer government remains more favourable than most of G7 counterparts

Undeniably, the renewed underperformance of Gilts this week broadly reflects the view that any potential Labour leadership candidate is unlikely to be any more or at least as fiscally responsible than the current Starmer/Reeves partnership and their pledges to have the current budget in balance and public debt declining by the final year of the parliament. While fiscal consolidation has been gradual to this point due to the backloaded nature of some revenue-raising measures, at least before the oil supply shock the OBR assessed that the Government's current policies were consistent with its fiscal rules. And as flagged by the IMF, the UK's fiscal trajectory remains more favourable than most of its G7 compatriots, if only by achieving a marginal budget surplus and plateau in the debt profile at the end of the horizon. Moreover, thanks in part to a better tax-take in FY25/6, public sector net borrowing (PSNB) as a share of GDP has fallen to a six-year low (4.3%), allowing the UK DMO to revise down its plans for Gilt issuance in the current financial year. And the OBR expects PSNB to decline to 3.6% of GDP in FY26/7, converging to 2.5% by FY29/30. Of course, the impact of the oil shock on inflation, GDP growth and borrowing costs poses a non-negligible threat to the government's fiscal headroom.

Left-leaning candidate likely to loosen fiscal policy despite market constraints

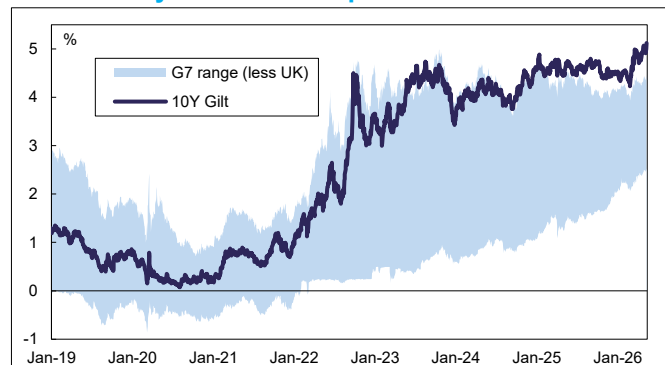
Impatience for change and quick wins amongst Labour MPs would suggest that whoever succeeds Starmer might be prepared to put fiscal policy on a somewhat more accommodating path. Certainly, various proposals from different camps (such as the [Renewal](#) and [Growth](#) groups) appear to favour a more expansionary mandate. But given market constraints, we would expect only fiscal tinkering at the margins, with for example some wealth-related tax increases to fund extra spending. A more left-leaning government might also shift some borrowing streams of public sector entities off-budget to be outside the scope of the fiscal rules. Given the ongoing hit to the Treasury's balance sheet from higher interest rates and inflation, there would also be louder calls to end the BoE's QT programme and to reduce issuance of now-costly linkers. While we suspect that Streeting would unlikely stray significantly from the fiscal rules, and Reeves might be retained as Chancellor for a short transition period, a more left-leaning Prime Minister might also try to shift to an easier longer-term debt rule (i.e. effectively

UK: May 7 local elections – elected councillors*



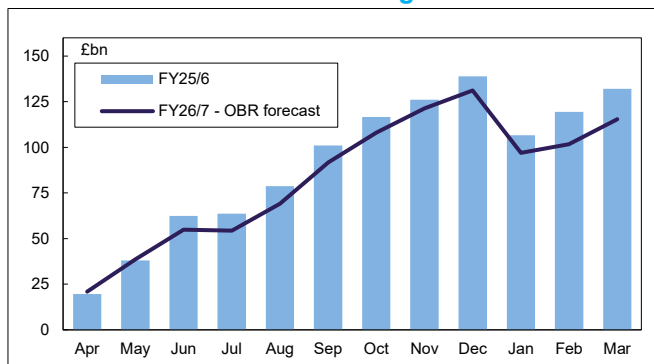
*Results of local council elections in England contested on May 7. The shaded bars illustrate the status of contested seats based on previous elections.
 Source: BBC and Daiwa Capital Markets Europe Ltd.

UK: 10 Y Gilt yield & G7 comparison



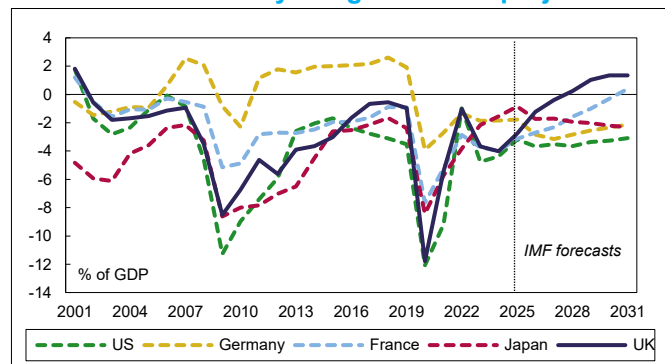
Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

UK: Public sector net borrowing



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

G7 countries: Primary budget balance projections



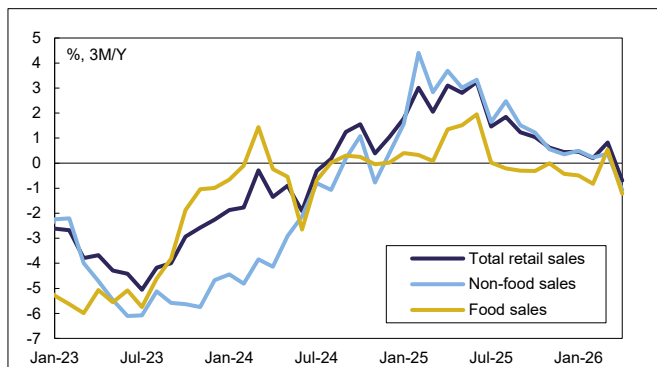
Source: IMF, Macrobond and Daiwa Capital Markets Europe Ltd.

extending the horizon of the goal from five to ten years), although that might not happen until the current budget is in balance. Nevertheless, while many backbench MPs would no doubt be cheerleaders for a wholesale shift in fiscal policy to larger deficits inspired by Modern Monetary Theory (MMT), we hope that sufficient lessons have been learned that the reckless fiscal irresponsibility of Liz Truss would not be repeated.

Retail survey reported weakest sales growth in 16 months, exacerbated by Easter timing

In terms of economic data, while Thursday's GDP release is expected to show solid growth in Q1, partly driven by unexpectedly strong household consumption, today's BRC retail monitor – echoing the April CBI survey – points to a sharp loss of sales momentum at the start of Q2 as the global energy shock hit consumer confidence and household income expectations. In particular, the BRC's measure of sales values fell a striking 3.0%Y/Y in April, with like-for-like sales down 3.4%Y/Y, both the most since November 2024. Admittedly, the weakness was exacerbated by the timing of Easter, which seemingly boosted sales in March this year (3.6%Y/Y) having flattered sales in April 2025 (7.0%Y/Y). This notwithstanding, like-for-like sales growth on a three-month basis slowed more than 1½ppts to 0.4%3M/Y, a 16-month low. Moreover, when adjusting for the BRC's shop price inflation, like-for-like sales volumes were down 0.7%3M/Y, the first decline in almost two years. Within the detail, adjusted growth in food sales volumes was similarly the weakest since mid-2024, while non-food sales volumes fell for the first time since November 2024. With households favouring precautionary saving in the current economic uncertainty, and balance sheets to be hit further by a jump in household energy tariffs from July, we expect spending on big-ticket items to remain very subdued through to at least the summer.

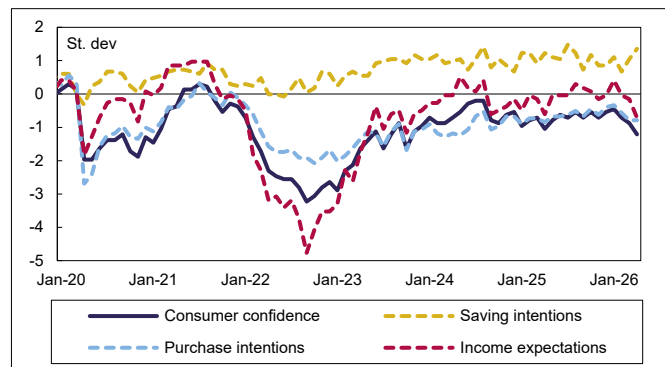
UK: BRC retail sales volumes*



*Adjusted using BRC shop price inflation.

Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Consumer confidence



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

The day ahead in the UK

Even without the absence of top-tier UK economic data, further political speculation regarding PM Starmer's longevity seems bound to occupy headlines on Wednesday. Nonetheless, Wednesday will bring some Bank-speak, with external MPC member Catherine Mann deliver a speech in London on the UK's international exposures and vulnerabilities. Although Mann was amongst a majority of MPC members who favoured an 'active' hold in April, like fellow MPC external Megan Greene, her paragraph in the MPC's minutes was more hawkish than the median rate-setter given concerns about the magnitude of potential second-round effects.

European calendar

Today's results

Economic data

Country	Release	Period	Actual	Market consensus/ <i>Daiwa forecast</i>	Previous	Revised
Germany	Final HICP (CPI) Y/Y%	Apr	2.9 (2.9)	<u>2.9 (2.9)</u>	2.8 (2.7)	-
	ZEW current situation (expectations) balance	May	-77.8 (-10.2)	-78.0 (-19.5)	-73.7 (-17.2)	-
Italy	Industrial production M/M% (Y/Y%)	Mar	0.7 (1.5)	0.2 (0.3)	0.1 (0.5)	0.2 (0.4)
UK	BRC retail monitor – like-for-like sales Y/Y%	Apr	-3.4	0.8	3.1	-

Auctions

Country	Auction
Germany	sold €4.63bn of 2.5% 2028 bonds at an average yield of 2.70%
UK	sold £4bn of 4.125% 2031 bonds at an average yield of 4.651%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

Country	BST	Release	Period	Market consensus/ <i>Daiwa forecast</i>	Previous
Euro area	10.00	GDP – second estimate Q/Q% (Y/Y%)	Q1	<u>0.1 (0.8)</u>	0.2 (1.2)
	10.00	Employment – first estimate Q/Q% (Y/Y)	Q1	-	0.2 (0.7)
	10.00	Industrial production M/M% (Y/Y%)	Mar	<u>0.5 (-2.4)</u>	0.4 (-0.6)
France	06.30	Unemployment rate %	Q1	7.8	7.7
	07.45	Final HICP (CPI) Y/Y%	Apr	<u>2.5 (2.2)</u>	2.0 (1.7)

Auctions and events

Euro area	20.00	ECB Chief Economist Lane to give speech in London			
	20.15	ECB President Lagarde to give speech in Germany			
Germany	10.30	Auction: to sell up to €1.0bn of 3.4% 2047 bonds			
	10.30	Auction: to sell up to €1.5bn of 2.5% 2054 bonds			
Italy	10.00	Auction: to sell up to €3bn of 2.4% 2029 bonds			
	10.00	Auction: to sell up to €3.25bn of 3.3% 2033 bonds			
	10.00	Auction: to sell up to €1.25bn of 2.95% 2038 bonds			
UK	18.00	BoE's Mann to give speech on the UK's international exposures and vulnerabilities at the LSE (text published at 15.00 GMT)			

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Access our research reports at:

<https://www.uk.daiwacm.com/ficc-research/research-reports>

This research report is produced by Daiwa Securities Co. Ltd., and/or its affiliates and is distributed by Daiwa Capital Markets Europe Limited ("DCME"). DCME is authorised and regulated by The Financial Conduct Authority and is a member of the London Stock Exchange. DCME and its affiliates may, from time to time, to the extent permitted by law, participate or invest in other financing transactions with the issuers of the securities referred to herein (the "Securities"), perform services for or solicit business from such issuers, and/or have a position or effect transactions in the Securities or derivatives or options thereof and/or may have acted as an underwriter during the past twelve months for the issuer of such securities. In addition, employees of DCME and its affiliates may have positions and effect transactions in such the Securities or derivatives or options thereof and may serve as Directors of such issuers. DCME may, to the extent permitted by applicable UK law and other applicable law or regulation, effect transactions in the Securities before this material is published to recipients.

This publication is intended only for investors who are professional clients as defined in MiFID II and should not be distributed to retail clients as defined in MiFID II. Should you enter into investment business with DCME's affiliates outside the United Kingdom, we are obliged to advise that the protection afforded by the United Kingdom regulatory system may not apply; in particular, the benefits of the Financial Services Compensation Scheme may not be available.

DCME has in place organisational arrangements for the prevention and avoidance of conflicts of interest. Our conflict management policy is available at <http://www.uk.daiwacm.com/about-us/corporate-governance-regulatory>. Regulatory disclosures of investment banking relationships are available at <https://daiwa3.bluematrix.com/sellside/Disclosures.action>.

Explanatory Document of Unregistered Credit Ratings

This report may use credit ratings assigned by rating agencies that are not registered with Japan's Financial Services Agency pursuant to Article 66, Paragraph 27 of the Financial Instruments and Exchange Act. Please review the relevant disclaimer regarding credit ratings issued by such agencies at:

https://drp.daiwa.co.jp/rp-daiwa/direct/reportDisclaimer/credit_ratings.pdf. If you need more information on this matter, please contact the Research Production Department of Daiwa Securities.

IMPORTANT

This report is provided as a reference for making investment decisions and is not intended to be a solicitation for investment. Investment decisions should be made at your own discretion and risk. Content herein is based on information available at the time the report was prepared and may be amended or otherwise changed in the future without notice. We make no representations as to the accuracy or completeness. Daiwa Capital Markets Europe Limited retains all rights related to the content of this report, which may not be redistributed or otherwise transmitted without prior consent.