

Euro wrap-up

Overview

- While euro area inflation rose to the highest level since September 2023 and core inflation surprised to the upside, Bunds followed USTs higher.
- Gilts also made gains as BoE Governor Bailey reiterated that tighter financial conditions allowed the MPC time to assess the impact of the energy shock.
- Wednesday will bring euro area PPI data for April and final European PMIs for May.

Emily Nicol
+44 20 7597 8331

Edward Maling
+44 20 7597 8030

Daily bond market movements

Bond	Yield	Change
BKO 2½ 06/28	2.610	-0.010
OBL 2½ 04/31	2.688	-0.025
DBR 2.9 02/36	2.972	-0.028
UKT 4¾ 03/28	4.300	-0.019
UKT 4¾ 03/31	4.417	-0.034
UKT 4¾ 10/35	4.853	-0.044

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

Euro area

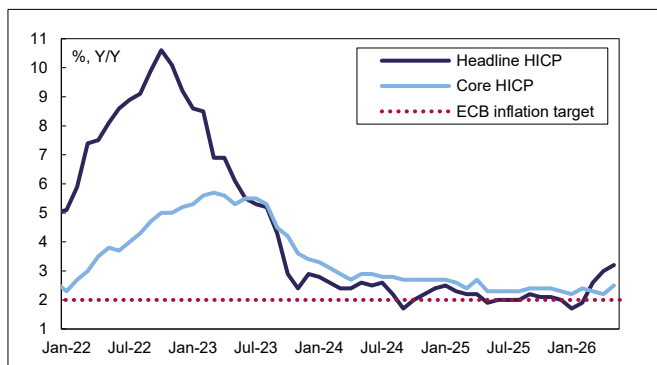
Inflation at highest level since Sep-23, with the core rate tracking ECB's severe scenario in Q2

Any lingering doubt about the outcome of this month's ECB policy meeting should have been dispelled by today's flash euro area inflation estimate for May, which will have reinforced the determination of the Governing Council to raise rates by 25bps next week and probably again in Q326. While the increase in headline HICP inflation by 0.2ppt to 3.2%Y/Y was broadly in line with expectations and the ECB's March baseline projection, it nevertheless represented the highest level since September 2023. More importantly, the limited detail published today suggested that indirect effects from the oil price shock are starting to feed through to non-energy components. Services inflation surprised to the upside, rising 0.5ppt to 3.5%Y/Y, matching the highest level since February 2025. A lack of granularity makes it difficult to confirm the underlying drivers of that increase. And national data point to a non-negligible rise in inflation of package holidays, which had previously moderated to a near-five-year low in March on calendar effects. But we suspect that higher fuel costs were also reflected in a range of transport services, including airfares. Moreover, despite relatively soft demand, inflation of non-energy industrial goods rose 0.1ppt to 0.9%Y/Y, the highest level in more than two years, perhaps reflecting the impact of higher costs of energy, intermediate goods and freight transport. As a result, euro area core inflation rose more than expected in May, by 0.3ppt to a 13-month high of 2.5%Y/Y, tracking 0.2ppt above the ECB's previous baseline forecast for Q226 and in line with its 'severe' scenario.

Energy inflation contained by fiscal measures, softness in food inflation unlikely to last

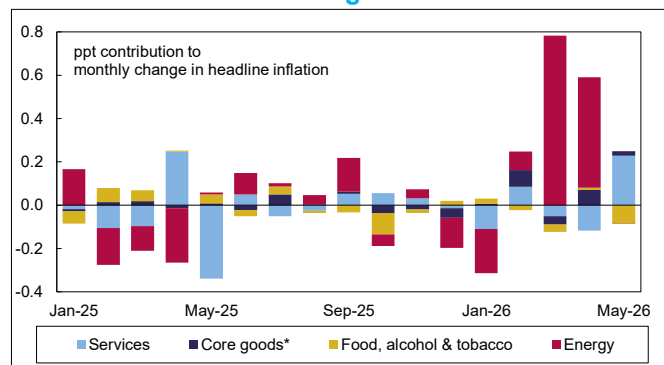
Having jumped cumulatively by 14ppts in March and April, energy inflation shifted only modestly higher in May, by 0.1ppt to 10.9%Y/Y. That was softer than the ECB projected in March, but nonetheless the highest since early 2023, and contributed a full percentage point to headline inflation. Energy inflation was also weighed by temporary tax cuts on auto fuel, which knocked roughly 3½ppts off German energy inflation and also contributed to moderations in Spain, Belgium and Ireland. Moreover, having risen in each May since 2014, food, alcohol and tobacco prices were unusually flat this year, pushing inflation of that component down 0.4ppt to 2.0%Y/Y, the lowest since October 2021. In part, that will have reflected favourable base effects in components such as coffee, chocolate and meat, which were highly elevated last year. But looking ahead, food prices will reflect higher input costs resulting from the conflict in the Middle East, with inflation of that component perhaps peaking in 12 to 18 months' time. Non-energy industrial goods inflation will also likely take a step up towards the end of the year as firms pass on higher costs. And indexation early next year will push services inflation back above 4.0%Y/Y. So, core inflation will likely maintain a steady uptrend through to Q127 when we expect it to peak above 3.0%Y/Y. While a gradual moderation in energy inflation will help to contain headline inflation, we still expect it to oscillate around 3%Y/Y over the coming 12 months, with risks still likely skewed to the upside and dependent on events in the Middle East.

Euro area: Headline & core inflation



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Drivers of change in headline inflation



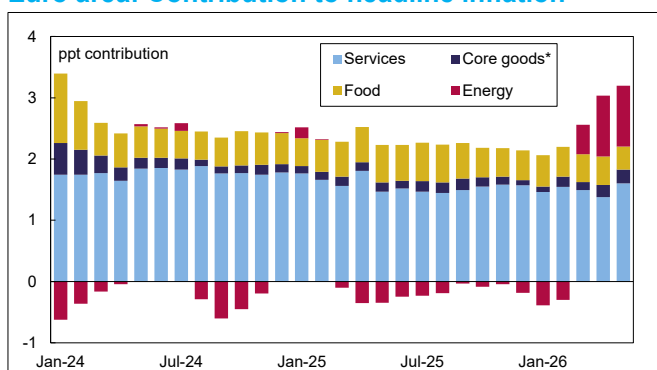
*Non-energy industrial goods.

Source: Macrobond and Daiwa Capital Markets Europe Ltd.

The day ahead in the euro area

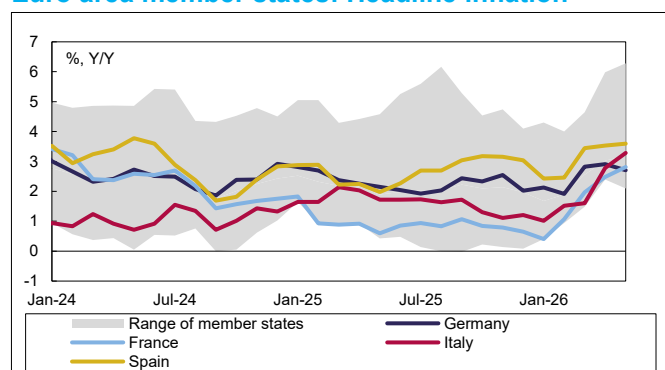
May's final PMIs will be the most newsworthy data out of the euro area on Wednesday. And not least because of the steep contraction raised by its [flash release](#), which suggested that business activity contracted (47.5) at its most pronounced rate since late-2023. So, taken alongside April's reading, this was consistent with signals of a non-negligible drop in GDP this quarter. Crucially, however, the [Commission's ESIs](#) cast doubt over the accuracy of that reading. The flash PMIs suggested that manufacturing production (51.0), albeit slowing, remained consistent with modest growth. But contrasting the stabilisation in the ESIs, the PMIs reported that services activity weakened considerably (46.4) and particularly in France (42.9, a post-pandemic low). Considering the extent of its weakness compared to last month's INSEE survey, the improvement to Monday's final manufacturing PMI, and the tendency of the flash French PMIs to go off-piste, we would not be surprised to see the French composite PMI – and by extension, that for the wider euro area – revised duly higher. Overall though, the PMIs should still confirm a further downturn in business activity midway through Q2 accompanied by further modest deteriorations in labour demand and sustained pressure in the price indices. Consistent with the latter signal, April's euro area PPI release will report another increase in input costs, likely to be rising at their highest rate in 3 years. But as the data from the member states suggested, underlying pressures should be shown to be well contained, while soft demand and renewables generation kept domestic energy production costs subdued.

Euro area: Contribution to headline inflation



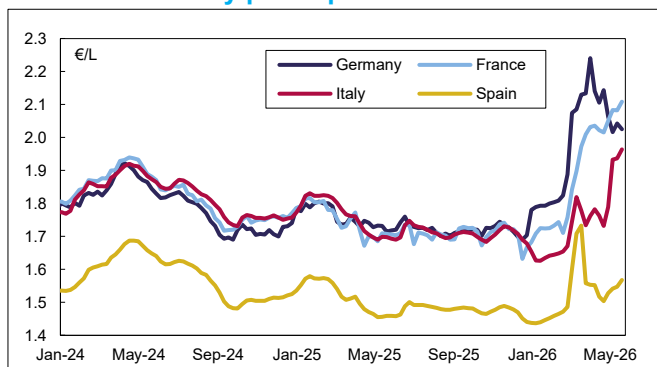
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area member states: Headline inflation



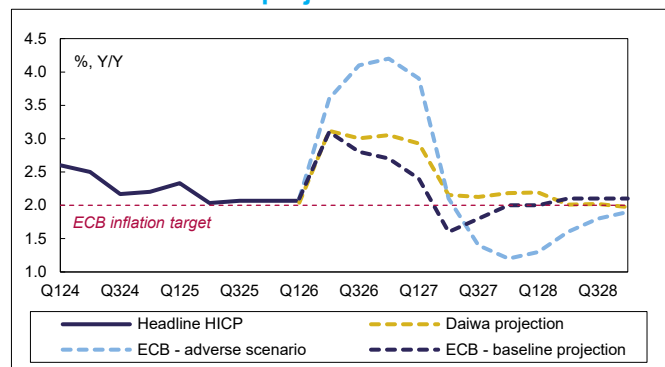
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Weekly petrol prices



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Inflation projections



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

UK

Tighter financial conditions not yet apparent in bank lending volumes, but resilience likely fleeting

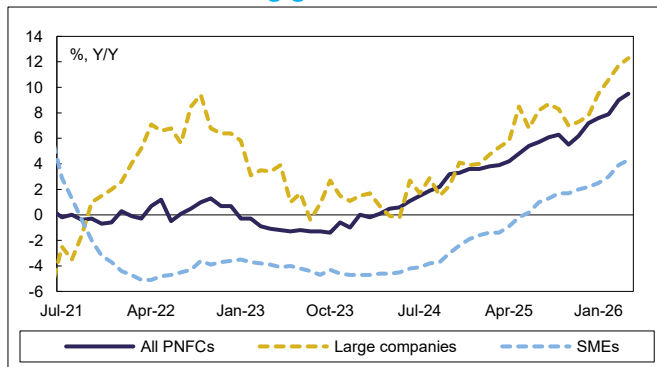
Despite a marked tightening of financial conditions in the three months since the outbreak of the Iran war, UK credit flows remained surprisingly firm through April. But that shouldn't lead the BoE to conclude that higher rates, beyond levels which markets have already priced in themselves, are required. Despite heightened uncertainty, business lending rose at the fastest rate in more than five years (9.5%Y/Y). Consumer credit flows remained broadly steady (£1.9bn), with credit card lending picking up to a three-month high (£0.8bn). So, while net credit flows to households moderated to a six-month low (£6.2bn) led by softer net mortgage lending (£4.4bn), that pullback in home-purchase loans was expected given the jump in March (revised up to £6.8bn). And household borrowing remained only slightly below the average of the past 10 months and not inconsistent with the long-run average. Moreover, a further rise in new mortgage approvals to a 16-month high of 65.9k points to additional support over the near term. But, as with the boost to mortgage lending in March, the pickup in approvals likely in part reflected panic among homebuyers in the face of rising mortgage rates. Indeed, while only matching their figure

for March (51.3k), approvals for remortgaging continued to track almost 15k above their average in 2025, and at the highest level since midway through the BoE's last hiking cycle in late-2022. Once the current boost to lending subsides, we might expect to see some modest payback in household borrowing. And with new mortgage rates reportedly up between 80-120bps in the first four months of the year to compound the effects of higher fuel and electricity bills, we expect higher borrowing costs to weigh on household consumption over coming quarters.

The day ahead in the UK

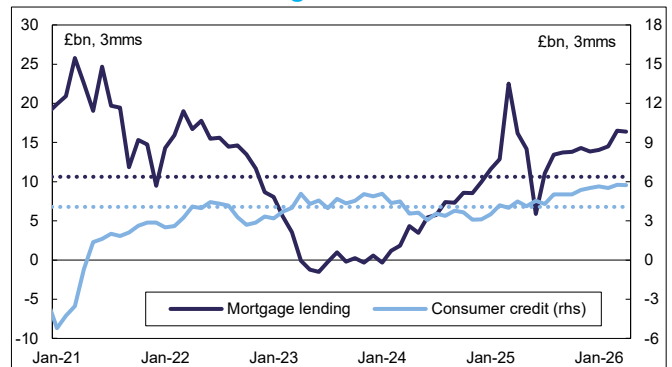
May's final PMIs will be expected to confirm signals of a sharp slowdown in UK growth momentum midway through Q2. According to the flash release, the headline composite output PMI fell by the most in four years (4.1pts) into contractionary territory (48.5) for the first month since Trump's 'Liberation Day' tariff announcements in April last year. As in the euro area, manufacturing output continued to benefit from stockpiling efforts and some production frontloading, with the output index up to a three-month high (52.2). But services weakened markedly (47.9, down 4.8pts) as firms also reported that further cuts to headcount were expected in the wake of cost pressures and a weaker demand outlook. They also continued to suggest that a significant share of those higher costs would be passed through to selling prices (60.6), albeit we note that implied a softer rate than had been signalled in April.

UK: Business lending growth



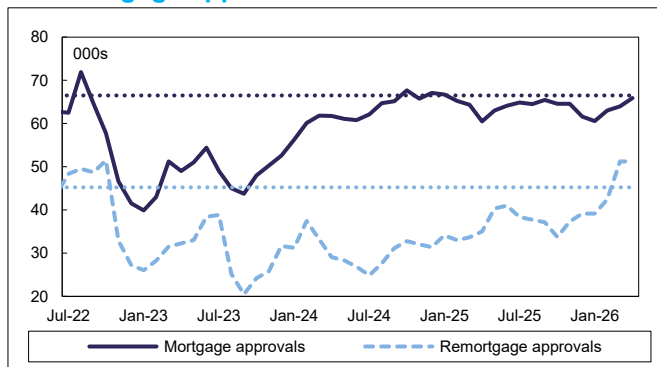
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Household lending*



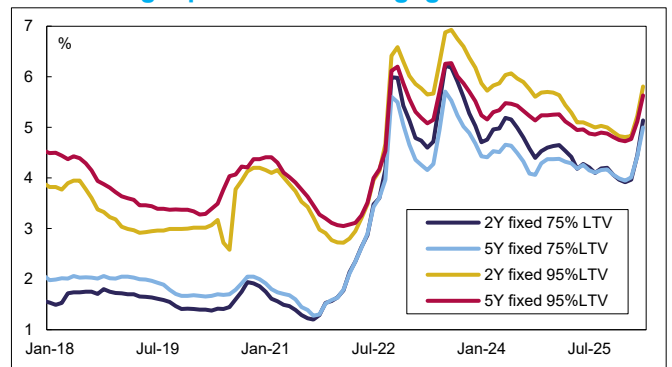
*Dotted lines show 5Y pre-pandemic average. Source: Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Mortgage approvals*



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

UK: Average quoted new mortgage rates







Source: Bloomberg and Daiwa Capital Markets Europe Ltd.



European calendar

Today's results

Economic data

Country	Release	Period	Actual	Market consensus/ <i>Daiwa forecast</i>	Previous	Revised
Euro area	 Preliminary headline (core) HICP Y/Y%	May	3.2 (2.5)	<u>3.3 (2.4)</u>	3.0 (2.2)	-
Spain	 Unemployment (net employment) change 000s	May	-36.3 (63.7)	-	-62.7 (41.8)	-
UK	 Net consumer credit £bn (Y/Y%)	Apr	1.9 (8.8)	1.7 (-)	1.9 (8.9)	-
	 Net mortgage lending £bn (mortgage approvals 000s)	Apr	4.4 (65.9)	5.4 (62.0)	6.2 (63.5)	6.8 (64.0)








Auctions

Country	Auction
Germany	 sold €3.857bn of 2.5% 2028 bonds at an average yield of 2.59%
UK	 sold £3.25bn of 4.625% 2037 green bonds at an average yield of 4.975%


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	09.00	 Final composite (services) PMI	May	<u>47.5 (46.4)</u>	48.8 (47.6)
	10.00	 PPI Y/Y%	Apr	4.9	2.1
Germany	08.55	 Final composite (services) PMI	May	<u>48.6 (47.8)</u>	48.4 (46.9)
France	08.50	 Final composite (services) PMI	May	<u>43.5 (42.9)</u>	47.6 (46.5)
Italy	08.45	 Composite (services) PMI	May	50.0 (49.2)	50.5 (49.8)
Spain	08.15	 Composite (services) PMI	May	48.9 (48.3)	48.7 (47.9)
UK	09.30	 Final composite (services) PMI	May	<u>48.5 (47.9)</u>	52.6 (52.7)

Auctions and events

UK	 10.00	Auction: to sell £1.6bn of 1.125% 2035 inflation-linked bonds
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Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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