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Interest & Exchange

Blurred 2020 Vision

Global Strategy: The temporary –and frontloaded– impact of the US fiscal reform will make it very difficult for the Fed to assess the US economy's real underlying health and, therefore, the speed at which to reverse the pro-cyclical stimulus. This increases the chances of a policy mistake, with potentially serious implications for financial markets. Despite the key 3% level in 10y UST yields recently being breached, we maintain our rate forecasts unchanged.

US Macro: The recent increase in the charge-off and delinquency rates for credit card loans in small banks raised significant concerns. Although it is true that the current levels of delinquency in that category are similar to those in previous economic recessions, after analysing all the delinquency data we do not see any evidence that this might be the case now. Moreover, banks' approach to new lending is still quite positive, with credit standards still at very good levels.

US Rates: The recent sell-off in nominal rates looks consistent with changes in inflation and monetary policy expectations, so the risk of a downward correction (like in March) looks less likely now. As a result, we do not see value in tactical longs at this point (like we did in February) and stick to our carry-efficient shorts in US rates (pay 2y2y and the belly in 2s5s10s).

EUR Macro: The Euro zone labour market is not only reinforcing a clear scenario of recovery but also entering a new phase of consolidation, including increasing upward pressure on salaries. In our view, this represents a change in the risks for inflation that should be incorporated in the ECB's statement progressively.

EUR Rates: Euro rates remain in a shallow bearish trend. Macro data suggest ECB caution, but the transition from APP- to forward guidance-centred policy is net bearish. Periphery spreads are underpinned by fundamentals. Even though further convergence is likely to be limited, we find the periphery yield/volatility ratio attractive, especially in SPGBs.

GBP Macro: Bank of England Governor Mark Carney's latest intervention in the interest rate debate struck a much more balanced tone than other recent MPC communications, leading the market to re-appraise the outlook for a May interest rate hike from the Bank. However, we believe that several aspects of Mr Carney's comments suggest that a 2018 UK rate hike is perhaps still less certain than even the corrected market pricing implies, and we remain comfortable with our view that UK monetary policy will stay on hold through 2018 and 2019.

GBP Rates: UK rates have continued to take directional cues from USD and EUR markets, and we are fairly neutral on the UK relative to those markets. The evolving supply environment has helped gilts to steepen, sharply exacerbated by Carney's latest warning on monetary policy and the subsequent soft GDP print. We believe this trend has much further to go and reiterate our existing steepeners: 1s5s in OIS, and 5s10s on the swap, gilt and even swap spread curves.

G-10 FX: The USD has been firmer over the last month. Trade issues remain a risk, despite the outlook for USD-positive rate hikes, Plus, the US economy remains strong and set to outperform its peers. EUR/USD has tended to move sideways since early February. We feel further EUR gains are hard to justify in the short term, given the interest rate and growth gap with the US. We still view the Pound as vulnerable. Brexit uncertainty and UK politics should remain a potential downside risk. Plus, recent downside data surprises favour caution, as they suggest a reduced chance that the BoE will hike rates in the near term.

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Santander's Interest Rate and FX Strategy Research in Bloomberg: SRFS <Go>.

#SanMacroStrategyViews: Our main views ... in a Tweet

	USD	EUR	GBP
Economic Outlook	We estimate GDP growth of 2.5% in 2018 and 2.6% in 2019, helped by private consumption and investment. Growth could smoothen in the short term, but should then recover.	Given stronger-than-expected external trade dynamics and sound domestic demand, we revise our GDP estimates to +2.4% for 2018E (vs +2.2%) and +2.2% in 2019E (vs +2.1%). All four major countries to contribute positively.	We expect UK GDP growth to remain at a c. 1.5% pace in 2018, with investment constrained by ongoing Brexit uncertainty. Falling inflation should boost reported consumption growth in 2H18.
Monetary Policy / Front-End	We maintain our long-held call of three 25bp hikes from the Fed in 2018, with an eye on core inflation, wages and DXY. Upside risk.	We expect the ECB to continue buying bonds (€30bn/mth) until Sep'18, followed by a small tapering in 4Q18, with the first rate hike around mid-2019. Watch the EUR.	We expect Bank Rate to remain at 0.5% through 2018 and no change in QE, although with the MPC communicating the prospect of hikes on the horizon.
Rates / Duration	The monetary policy normalization, healthy macro environment and potential changes in supply/demand equilibrium should weigh on USTs all along the curve.	Core rates remain in a shallow bearish trend and should rise through 2018, as the ECB heads slowly towards less accommodation. Recent macro figures, however, suggest some caution.	The market's conviction on pricing for UK hikes this year still looks too aggressive to us, especially after the disappointing data and Carney's intervention.
Curve / Slope	We remain bearish on the front end (pay 2y2y) but after this week's price action, further yield increases in the belly are limited. Play carry-efficient shorts (pay the belly in 2s5s10s).	With the front end out to 2-3y essentially pinned down, steepeners and barbells against the belly of the curve should still work as G7 rates continue to rise.	UK curves are unduly flat at all tenors, and we see more risk premium as warranted. They rebounded from the lows this week, but should go further.
Spreads	Gradually unwinding SOMA reinvestments pose a risk for USTs. We like swap spread wideners (bearish USTs), especially in the ultra-long end.	Economic recovery, further ratings upgrades and decelerating supply underpin SPGBs, which have shown defensive properties in sell-offs. BTPs are priced for very little policy risk.	The widening into fiscal year-end has largely unwound, but 10y, in particular, still looks too wide. 5s10s gilts look even more excessively flat than swaps.
Volatility	The bottom right corner has richened significantly compared to recent ranges, but in line with delivered vols. Gamma, on the contrary, starts to look rich vs. delivered.	Ultra-low realised volatility with the Central bank dedicated to keeping it that way continues to depress implied vols. Longer-tenor, shorter-expiry swaption premia look rather low.	Implied vols towards the top-left have stabilized off their lows. But long tenors, in particular, still look too sedate for the secular economic uncertainty in the UK.
Inflation / Break-evens	The bounce back in core inflation and the positive tone in oil prices are helping breakevens recover. We believe that the front end in particular, is still below this year's highs, offers value.	We expect higher ILS but no sharp rise near term. The ILS term structure looks flat relative to 5y spot, especially in 10y and 15y. 15y SPGB€i looks cheap in RV.	A decline in CPI is now well under way, and it is likely to fall below 2% before the end of the year. Wage growth remains pivotal, and so far underwhelming.
FX	The USD remains relatively weak, but has perked up recently. Political and trade concerns may still weigh. The mix of a strong economy and further Fed rate hikes in 2018 should provide support.	EUR/USD has weakened as data has started to surprise to the downside. The ECB's status quo stance and wider US-EU yields should weigh eventually, but for now are being ignored.	Sterling is slipping as the USD regains its footing. Plus, the Pound remains vulnerable to slower GDP, CPI and political/Brexit uncertainty, as well as the market pricing out near-term rate hikes.

Source: Santander Economics, Rates and FX Strategy Research. For a full list of contributors, please see contact details on page 30.

Our main recommendations (More Trading Recommendations in the Strategy Sections)

	USD	EUR	GBP
Govies	**Sell the 30y UST in ASW** Entry level = 18bp. Target level = 30bp. Stop loss = 12bp	**1) BTP-SPGB 2025-2024 box trade** at -2bp.Target -12bp. **2) buy SPGB€i 1% 11/30 vs. OAT€i 0.7% 7/30** at 72bp. Target 60bp.	**Sell 10y gilt spreads versus 5y (box steepener)** Current level = 21.5bp. Target level = 31bp. Stop loss = 20bp.
Rates	**1) Pay the belly in 2s5s10s** Entry = 3bp. Target = 10bp. SL= 0bp **2) Receive 15y vs. pay 5y5y** Entry sprd level = 7bp.Target = 30bp. Stop loss = -5bp **3) Pay 2y2y in USD swaps** Entry level = 2.90%.Target = 3.30%. Stop loss = 2.70%	**1) ILS 10f5y vs 5y steepener** at 57bp. Target = 65bp **2) EUR 5-7-20y butterfly (receive 7y)** at -26bp. Target = -30bp	**1) GBP 1s5s OIS steepener.** Current level = 41bp. Target level = 50bp. Stop loss = 36bp. **2) Buy 40y gilt inflation break-even (outright or vs. 10y).** Current level = 317bp. Target level = 325bp. Stop loss = 313bp.
FX	**Buy USD/JPY** at 109.30 target= 114, with a stop loss at 107.00	**Sell EUR/NOK** original entry at 9.80, Target = 9.30. SL = 10.05.	**Sell GBP/USD** original entry at 1.4050, target= 1.3600, with a stop loss at 1.4200

Global Strategy: Three is the magic number

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- **The temporary –and frontloaded– impact of the US fiscal reform will make it very difficult for the Fed to assess the US economy's real underlying health and, therefore, the speed at which to reverse the pro-cyclical stimulus. This increases the chances of a policy mistake, with potentially serious implications for financial markets. Despite the key 3% level in 10y UST yields recently being breached, we maintain our rate forecasts unchanged.**

Global recovery: broader and stronger, but…

In its recent World Economic Outlook, the IMF confirmed our main macro views, but also some of our fears. First, the breadth and strength of the current global economic upswing. While acknowledging the structural headwinds we have mentioned in the past, the present recovery is the most universal we have seen in decades and, according to the IMF, none of the Top-50 world countries is currently suffering a sharp slowdown.

In terms of the global economy, the IMF expects GDP growth just shy of 4% for both 2018 and 2019, the highest since 2011. These forecasts are clearly higher than their own projections last October (+0.5% and +0.4% respect.). Moreover, although the US is the country with the largest upgrade, thanks to its tax reform, the truth is that the growth expectations for most other advanced economies have also been raised in this period (Table 1).

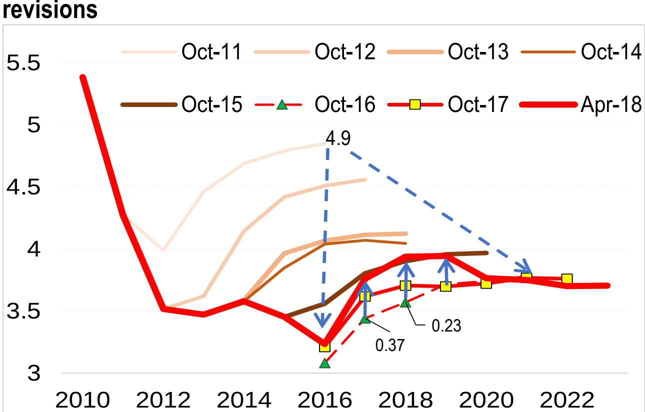
Another interesting aspect, as highlighted in the past, is that the trend of sequential downward revisions to growth expectations seems to have come to an end (Chart 1), with the revisions now being upwards, at least for the next two years. Also interesting, and with all the necessary caveats given the key electoral dates in Mexico and Brazil in 2H18, many emerging and developing economies do not seem to be benefitting that much from the advanced economies' macro improvements, with most barely seeing their growth expectations upgraded apart from these two big Latam countries.

So, for the time being, with financial conditions still clearly supportive, and investment spending leading the recent recovery, it would seem that the risk of a significant deceleration in the next 12 months is limited.

Table 1: IMF global growth expectations and revisions

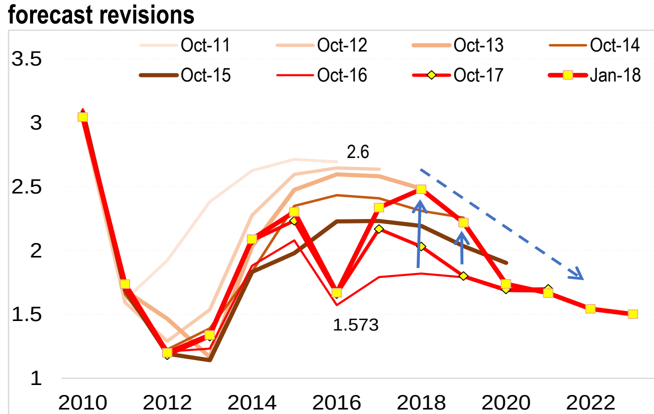
	2017	2018	2019	Δ vs Oct'17 2018	Δ vs Oct'17 2019
World	3.8	**3.9**	3.9	0.2	0.2
Advanced	2.3	**2.5**	2.2	0.5	0.4
US	2.3	**2.9**	2.7	0.6	0.8
Euro Zone	2.3	**2.4**	2.0	0.5	0.3
Germany	2.5	**2.5**	2.0	0.7	0.5
France	1.8	**2.1**	2.0	0.3	0.1
Italy	1.5	**1.5**	1.1	0.4	0.2
Spain	3.1	**2.8**	2.2	0.3	0.2
Japan	1.7	**1.2**	0.9	0.5	0.1
UK	1.8	**1.6**	1.5	0.1	-0.1
Canada	3.0	**2.1**	2.0	0	0.3
EM & Devl	4.8	**4.9**	5.1	0	0.1
Russia	1.5	**1.7**	1.5	0.1	0
China	6.9	**6.6**	6.4	0.1	0.1
India	6.7	**7.4**	7.8	0	0
Brazil	1.0	**2.3**	2.5	0.8	0.5
Mexico	2.0	**2.3**	3.0	0.4	0.7

Chart 1: Global growth, IMF expectations and forecast revisions



Source: IMF, Santander

Chart 2: Advanced economies' growth, IMF expectations and forecast revisions



Source: IMF, Santander

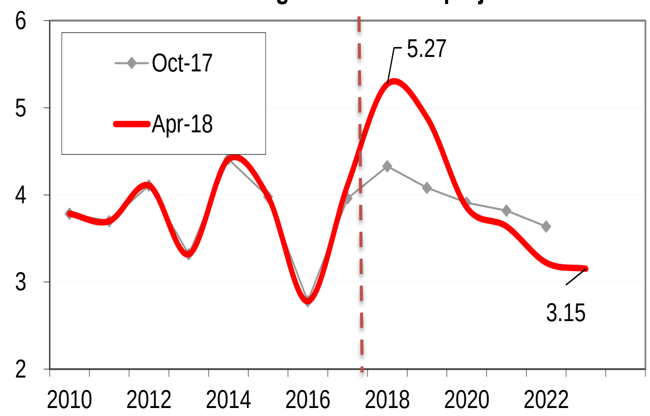
Our main concern is not the near future, but we are getting more worried about the macro and financial outlook beyond the next couple of years, as global growth is projected to soften from 2020 onwards. And most of these countries will have to deal with it with much higher public debt levels than before the crisis, thus limiting any possible fiscal aid in case of a pronounced slowdown. Additionally, monetary policy coffers will not have had enough time to be refilled. According to current money market futures, in the ten largest advanced economies the average three-month interbank rate at the end of 2019 will be 'just' 120bp –i.e., not much room to ease if needed.

Front-loading growth, to be paid for at a later stage

The fiscal reform recently approved in the US will obviously boost economic growth there in coming quarters. The IMF, for instance, has revised its 2018 and 2019 US GDP growth expectations higher by 0.59% and 0.75%, respectively (+0.94% and +0.8% in nominal terms, see Chart 3), since last October. But it left its GDP forecasts for 2020 and 2021 basically unchanged, while its 2022 figure has been shaved by 0.2% in real terms and by 0.42% in nominal terms. Admitting that the precision of any macro forecasts in five years' time is very limited, to say the least, we think it helps to prove the point we have made in the past –i.e., that the US tax reform is more micro than macro and, to a large extent, simply brings growth forward, rather than improving this country's actual growth potential. And at a very high cost.

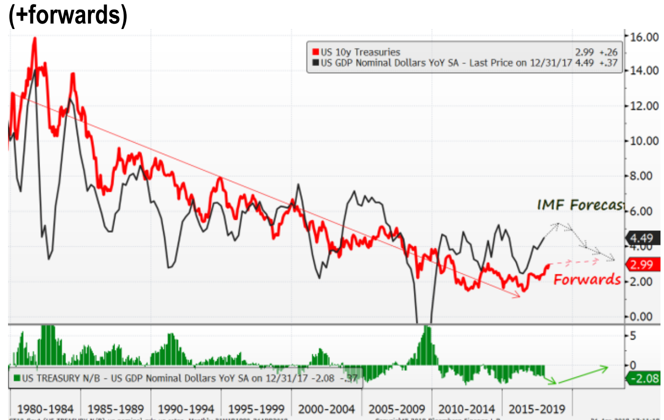
In fact, if we were to believe in these IMF forecasts wholeheartedly, US nominal GDP in five years' time would be 'just' 3.15% –i.e., below current 10y rates forward to that date (Chart 4). Even acknowledging that current rates are below fair value and at historically low levels given the stage of the cycle due to the extremely accommodative monetary conditions and sovereign bond holdings by the largest central banks, it would be the first time long-end US rates were below nominal growth since the aftermath of the GFC.

Chart 3: US nominal GDP growth and IMF projections



Source: Bloomberg, Santander

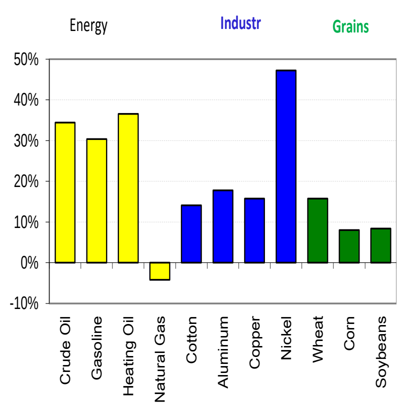
Chart 4: US nominal GDP (+ IMF forecast) vs 10y UST yield (+forwards)



Source: Bloomberg, Santander

Potentially misguided Fed and 2020 vision

Chart 5: Commodity prices; change in the last 12 months



Source: Bloomberg, Santander

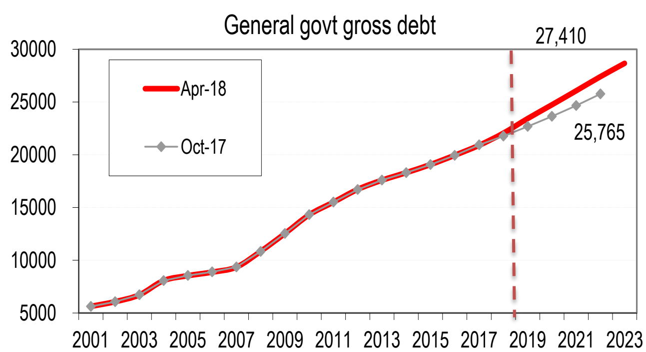
For us, the main threat is not a US growth slowdown to below potential once the expansionary impact of the recent fiscal measures goes into reverse, as cycles cannot last forever. Our main fear is that, in an environment where actual growth, business expectations, earnings (and therefore equity prices) or even wages might be temporarily boosted by this reform, it will be very difficult for the Fed to assess the US economy's true underlying health and, therefore, the speed at which the pro-cyclical stimulus should be reversed.

And this macro outlook will be even more blurred by the potential impact on US **inflation** of the USD's recent decline as, despite its recent rebound, the trade-weighted USD is -11% vs January 2017 levels. And neither can we ignore the recent upswing in **commodity prices** (margin chart), that could also help push US inflation higher in coming months. In this environment, we fear the present, mostly fiscal-led, hump in US nominal growth could lead the Fed to take its monetary policy to an unnecessarily tight stance.

In fact, the Fed is currently forecasting that it will take its monetary policy into a tighter-than-neutral stance, as the median 'dot' of its members' forecasts for Fed Funds at the end of 2020 (a 3.25-3.5% band, with two FOMC members expecting official rates above 4%) is 50bp above their 'longer run' projection. The market, though, continues to show its skepticism about the need for such a tightening stance as, while the Fed (the median dot) sees three additional hikes in 2019, ED and FF futures are pricing in just 40bp, and basically no further hikes for 2020 (vs the two hikes expected by the Fed).

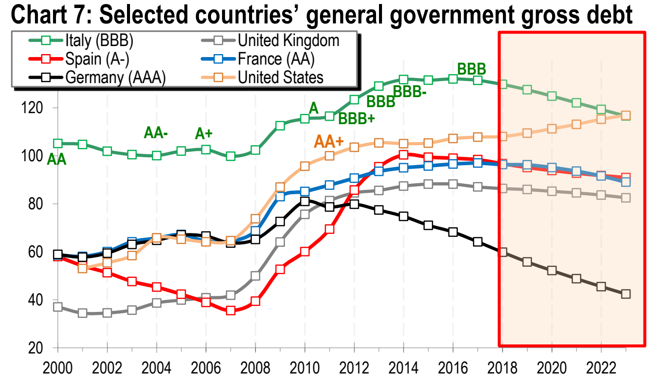
We are much more in line with the market in this regard, not only given the asymmetrical risks and the tepid structural inflationary trend, but also our deep concerns about US fiscal debt. As highlighted by both the Congressional Budget Office and the IMF, the recent US tax reform will accelerate the already steep profile of US public debt we have been writing about for months. We have updated (and 'zoomed') below the chart we showed last month, including, on top of the already massive increase in US public debt, the additional impact of the US tax reform which, according to the IMF, will add an extra $1.7trn to US public debt over the next five years. According to its projections, the US public gross debt-to-GDP level will already be above Italy's (BBB/Baa2) in 2023, at 117% (Chart 7).

Chart 6: US (gross and net) public debt (USD, trn)



Source: Bloomberg, Santander

Chart 7: Selected countries' general government gross debt



Source: IMF, Santander

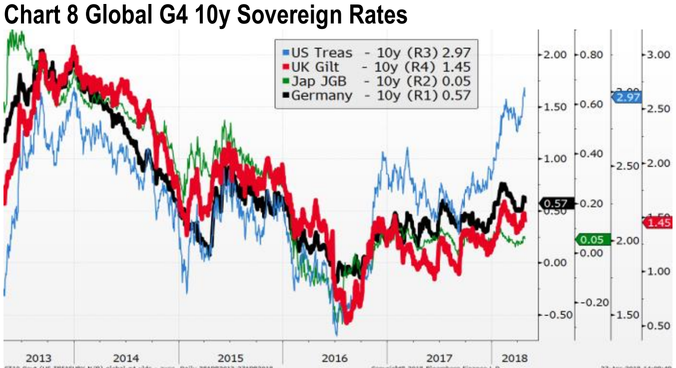
Is three the magic number?

We maintain our long-held call of the 10y UST yield at 3.25% by year-end

Given the lack of surprises in the recently released US macro data, we think these fiscal concerns have contributed to the recent spike in US long-end rates that, for the first time since 2011, have pierced the key 3% level, although without much conviction. We maintain our long-held call of the 10y UST yield at 3.25% by year-end, despite how close we now are to that target and the sharp YTD increase in rates. At around the current levels, we believe US rates start to offer value, and not only for fixed income, but other asset investors. At the end of the day, not even the 50y BTP offers a yield above 3%. As mentioned in the past (see our Feb'18 I&E), given the massive bond supply these huge fiscal deficits will bring, potential investors wanting to obtain such yields could feel time is on their side and wait for higher yield levels before jumping in.

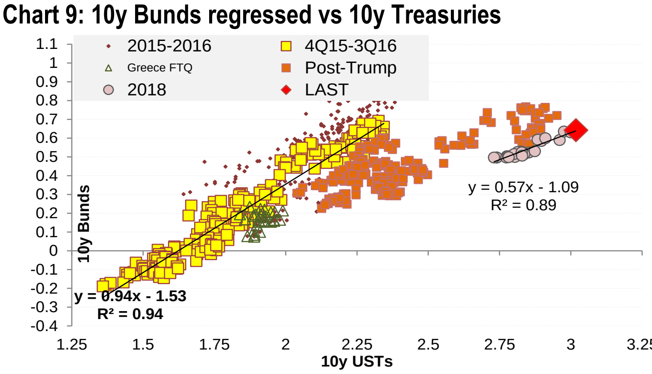
Across the Atlantic there has been no real news regarding the ECB, especially with the EUR at current levels. But this is not a surprise for us as, for quite some time now, our FX strategists have been maintaining that the EUR was overbought and a correction towards the $1.21 levels was likely, before then resuming an upward trend later in the year. Given the different supply/demand dynamics (for comparison purposes the IMF expects the EZ debt-to-GDP ratio to be at 72% in 2023), Bunds are only replicating 55-60% of the moves in USTs, and we believe this beta will remain around current levels until the latter part of the year, when the ECB ends its bond purchases.

Chart 8 Global G4 10y Sovereign Rates



Source: Bloomberg, Santander

Chart 9: 10y Bunds regressed vs 10y Treasuries



Source: Bloomberg, Santander

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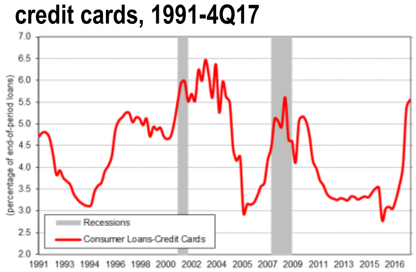
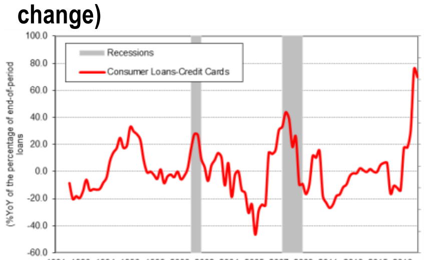
The market seems to be looking for evidence that could point to the end of the US economic cycle. The recent increase in the charge-off and delinquency rates for credit card loans in small banks raised significant concerns. Although it is true that the current levels of delinquency in that category are similar to those in previous economic recessions, after analysing all the delinquency data we do not see any evidence that this might be the case now. Moreover, banks' approach to new lending is still quite positive, with credit standards still at very good levels.

Chart 10: US – Small banks' delinquency rates, consumer loans-credit cards, 1991-4Q17



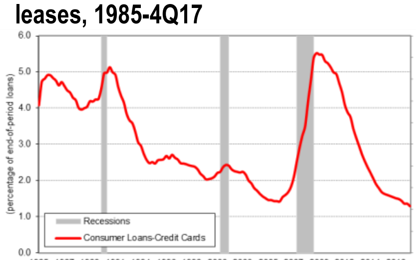
Source: FED, BEA, Santander.

Chart 11: US – Small banks' delinquency rates, consumer loans-credit cards, 1991-4Q17 (YoY% change)



Source: FED, BEA, Santander.

Chart 12: US – Small banks' delinquency rates, total loans and leases, 1985-4Q17



Source: FED, BEA, Santander.

Problems in the financial system in the short run?

The US economic cycle continues defying history, entering its ninth year in a row of positive growth rates and so far skipping any recession scenario. In our view, this positive economic performance should be maintained in the 2018-19E period at least, with GDP growth rates possibly remaining above the 2.5% level in both years. Although we believe that fundamentals are still strong enough to keep the economy growing, and the recently approved fiscal package could also give an extra push, the market seems to have doubts about that optimistic scenario. This is why, in our view, the market is giving more credibility to any statistic that might point to a future recession scenario than it probably deserves, in our view. We believe that drawing such an important conclusion –the US economic heading into recession– from a single number is, at the very least, risky.

The recent increase in the charge-off and delinquency rates on consumer loans (credit cards) is an interesting example of the scenario we explain above. Those numbers have recently entered into recession territory and some market participants have come to the conclusion that the financial sector –and, ultimately, the whole economy– is in trouble. We disagree with that view and look into those numbers in detail.

Delinquency problems on the horizon?

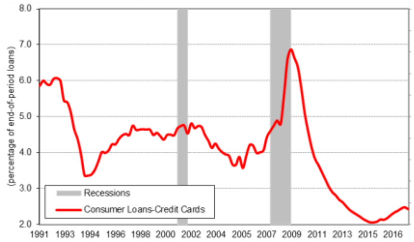
According to the Federal Reserve data, there was a sharp increase in the delinquency rate at small banks (all but the largest 100 banks) in the credit cards category, within consumer loans. That is, the delinquency rate (defined by the Fed as those past due 30 days or more and still accruing interest, as well as those in non-accrual status, and measured as a percentage of end-of-period loans) rose to 5.5% in 4Q17 from just 3.27% in 4Q16. That is, delinquency has increased by more than 2.0 percentage points in one year (annual growth of 69.7%). This is the highest level since the 5.61% reached in 4Q08, when the US economy was in recession. Moreover, the 4Q17 annual growth rate of 69.7% is the second highest in history, after the 75.7% posted in 3Q18. The conclusion drawn from those numbers was quite easy for some market participants: since the last two times this rate was above the 5.0% mark (2001 and 2008) coincided with the US economy being in recession, we could now be facing the same scenario. We disagree with that view.

Analysing all small banks' (all excluding the 100 largest banks) delinquency data shows a different picture

Although the increase in the small banks' credit card delinquency rates could look very negative, analysing the rest of the numbers shows a different picture. Despite this increase in credit card delinquency rates, total consumer loans have not experienced any deterioration. In fact, the delinquency rate in 4Q17 (2.05%) was lower than in 4Q16 (2.15%), with the rate for the other consumer loans category declining from 1.83% in 4Q16 to 1.56% in 4Q17, its lowest ever. When we look at delinquencies in the rest of the categories at small banks, we observe that: (1) total real estate loans show the lowest level ever (1.19% in 4Q17); (2) commercial and industrial loans are almost at the lowest point ever (1.6% in 4Q17 versus the lowest on record, 1.51% in 4Q14); and (3) the percentage for total loans and leases was 1.29% in 4Q17, down from 1.49% in 4Q16, again, the lowest level on record.

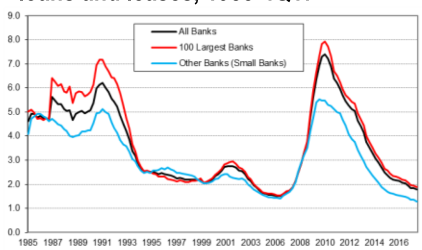
Finally, charge-off rates (defined by the Fed as the value of loans and leases removed from the books and charged against loss reserves, and measured net of recoveries as a percentage of average loans and annualized) for total loans and leases fell to just 0.19% in 4Q17, down from 0.24% in 4Q16 and, again, at the lowest level ever (data compiled since 1985).

Chart 13: US – 100 largest banks' delinquency rates, consumer loans-credit cards, 1991-4Q17



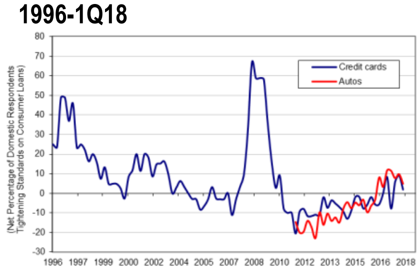
Source: BLS and Santander.

Chart 14: US – Delinquency rates, total loans and leases, 1985-4Q17



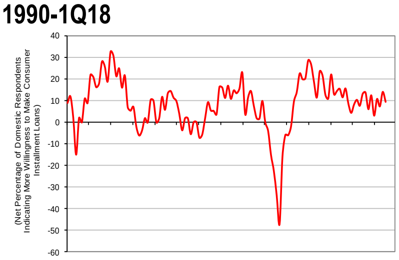
Source: BLS and Santander.

Chart 15: US – Credit standards for consumer loans-credit cards & autos, 1996-1Q18



Source: Fed.

Chart 16: US – Net % of respondents reporting increased willingness to make consumer instalment loans, 1990-1Q18



Source: Fed.

Good numbers at the 100 largest banks with low delinquencies in all loan categories

Our analysis of the numbers at the largest financial institutions does not show any stress in terms of either delinquencies or charge-off rates. The delinquency rate for total loans and leases fell to 1.9% in 4Q17, which is 12% below the level in the same quarter of 2016 (2.16%). Delinquencies in commercial and industrial loans, rate, which went up in 2016 (1.54% in 3Q16), dropped to just 1.1% in 4Q17 (-26.2%) and could keep falling in coming quarters. The news is also good for credit card consumer loans since, despite the delinquency rate increasing to 2.43% in 4Q17 from 2.33% in 4Q16, the current level is still well below the historical average (4.09% since 1991) and significantly below the level seen in the previous recession (6.87% in 2Q09). Lastly, it is interesting to see how the rate of delinquencies in residential real estate loans, despite falling since the peak in 1Q10 (13.04%), remains above the levels posted ahead of the economic recession (3.98% in 4Q17 versus the 2.25% average in 1991-2006). In summary, we do not see any risk, in the current economic scenario, of delinquency and charge-off rates going up sharply again and putting the financial sector in a difficult position. Indeed, if we were really heading towards that negative scenario, US banks would already have taken some precautionary measures as regards their lending activity. And this has not happened, as evidenced by the Federal Reserve Senior Loan Officer Opinion Survey on Bank Lending Practices (SBLP).

Banks have not tightened credit standards and remain willing to make consumer instalment loans

According to the Fed's SBLP, banks have not changed their credit standards for new lending. Rather, they have basically maintained, or even improved in some cases, their credit standards in most of the categories. For consumer loans, banks have relaxed their credit standards, with the net percentage of domestic respondents to have tightened standards declining to: 1.9% for credit card loans in 1Q18 from 9.1% in 4Q17; 4.9% on auto loans in 1Q18 from 9.8% in 4Q17; and at 0.0% for loans excluding autos and credit cards in 1Q18 from -1.6% in 4Q17 and 2.9% in 3Q17. It is worth bearing in mind that those rates jumped to more than 65% in 2008, when the recession hit the US economy hard. Moreover, US banks' willingness to make consumer instalment loans remains stable and in positive territory (9.5% in 1Q18 versus an average of 10.0% since 2016). On the contrary, banks are not highlighting stronger demand for consumer loans. The situation is similar in residential mortgage loans, with banks relaxing their credit standards, but demand actually being weaker in recent months.

The situation in terms of Commercial and Industrial loans (C&IL) is also positive, with banks relaxing credit standards for both large and medium companies and small companies. Importantly, although spreads on loan rates over banks' cost of funds are still narrowing, the levels are not as low as in the past, with companies still not showing much stronger demand for C&I loans.

US Rates Strategy: No clear risk of a downward correction

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- **The recent sell-off in nominal rates looks consistent with changes in inflation and monetary policy expectations, so the risk of a downward correction (like in March) looks less likely now. As a result, we do not see value in tactical longs at this point (like we did in February) and stick to our carry-efficient shorts in US rates (pay 2y2y and the belly in 2s5s10s).**

History repeating itself? It doesn't look like it

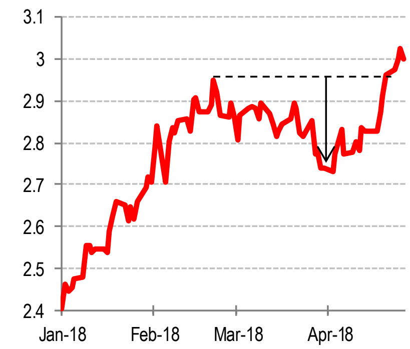
US rates have sold off again in the past few sessions, with the 10y tenor flirting with the 3% mark again as we write. We already lived through a similar situation back in February, when we argued that the move had been too fast to consolidate at those levels and then we opted to pause our strategical shorts on the belly to adopt tactical longs (see 'Value in receiving the belly vs. the wings' included in our 2 March I&E report). This strategy, by the way, proved right and we decided to close with profits last month in order to resume our bearish positioning on USTs all along the curve through carry-efficient shorts (see 'Time to reload carry-efficient shorts', included in our 6 April I&E report). Is history repeating itself, or might the upward trend be with us for good this time?

Here, we analyse the recent price action, taking the same approach as two months ago and, this time, it is not that clear that a downward correction could occur imminently. If, back in February, we found that the increase in nominal rates was not fully explained by the change in monetary policy and inflation expectations, this time the situation looks a bit different. And that makes us feel less comfortable with openly calling a downward correction in US rates at this stage.

As shown in Chart 19, now the cumulative year-to-date change in USD swap rates, all along the curve, seems to be essentially explained by the combination of changes in monetary policy (as measured by FF futures) and inflation (as measured by IL swaps) expectations, as the difference between market levels and our valuations is less than 5bp all along the curve. This situation contrasts with that in mid-February, when the model was suggesting that the sell-off in nominal rates in the belly and the long end of the curve was overshooting the change in the underlying fundamentals by around 20bp (see Chart 20).

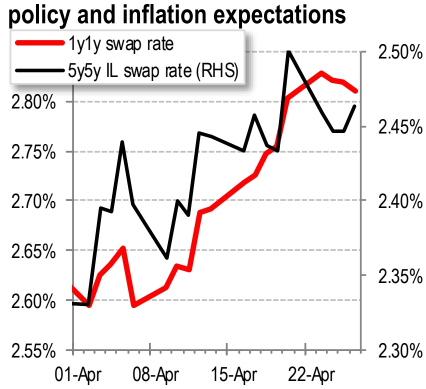
This kind of analysis, while simple, has worked really well in anticipating possible market dislocations in USD rates since January. Therefore, we tend to think that any downward correction from these levels now, even if possible, is unlikely to be as deep and protracted as it was in March.

Chart 17: 10y UST yield – year-to-date performance



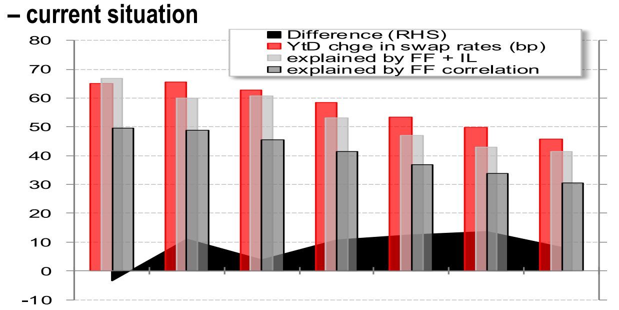
Source: Bloomberg, Santander.

Chart 18: Recent price action in monetary policy and inflation expectations



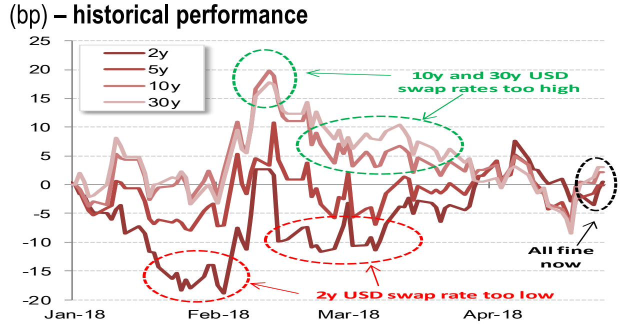
Source: Bloomberg, Santander.

Chart 19: Dislocations in USD swap rates compared to YtD changes in (beta-weighted) FF futures and in USD IL swaps (bp) **– current situation**



* For more details on this model please refer to our 2 February 2018 I&E, page 12. Source: Bloomberg, Santander.

Chart 20: Dislocations in USD swap rates compared to YtD changes in (beta-weighted) FF futures and in USD IL swaps (bp) **– historical performance**



* For more details on this model please refer to our 2 February 2018 I&E, page 12. Source: Bloomberg, Santander.

Sticking to the script: carry-efficient shorts remain the most attractive strategy

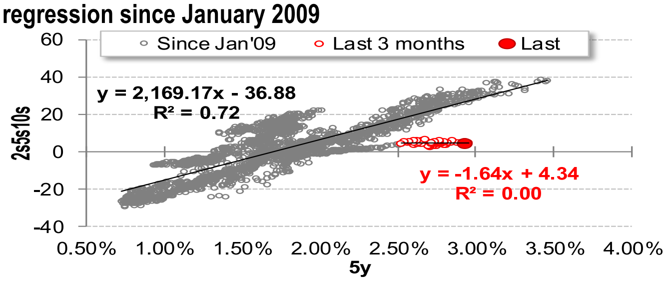
If the 3% level is broken for good and, by then, fundamental indicators give a clearer signal, we would consider adopting tactical positions to accommodate to the new situation. But, for the time being, we feel comfortable maintaining our strategical positioning, prepared to capture what we expect to be a gradual bearish medium-term trend for US rates in the belly and long end of the curve, through positions that minimise the negative (or even turn positive the) cost of carry, hence offering some extra protection in case the market moves slightly against us or if it takes some time until the sell-off in US rates resumes. In this connection, we continue to see value in paying the belly in the 2s5s10s butterfly, as we discussed last month. This spread, which historically has shown significant directional behaviour (R2= 72% vs the 5y swap rate level since 2009, see Chart 21) has lagged behind in the recent price action (Chart 22). And we see this as an opportunity to go short US rates without incurring negative carry. As shown in Table 2, paying the belly in that fly yields a slightly positive 3m carry (+0.2bp) and the roll down should also play in our favour (+1.3bp in 3 months), clearly outperforming the metrics of just being short the 5y.

Table 2: 2s5s10s in USD swaps – 3m carry and roll-down analysis

	carry	roll-down	total
Receive 2y	3.6	3.2	6.8
Pay 5y	-2.3	-0.5	-2.8
Receive 10y	1.4	0.4	1.8
Pay the belly in 2s5s10s	0.2	1.3	**1.5**
compared to paying 5y	*2.5*	*1.8*	*4.3*

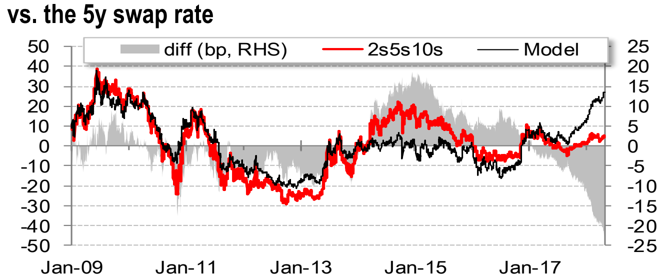
Source: Bloomberg, Santander.

Chart 21: 2s5s10s fly vs. 5y spot in USD swap rates – Linear regression since January 2009



Source: Bloomberg, Santander.

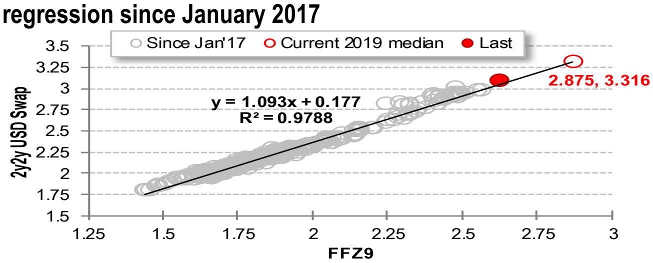
Chart 22: 2s5s10s fly model based on the historical correlation vs. the 5y swap rate



Source: Bloomberg, Santander.

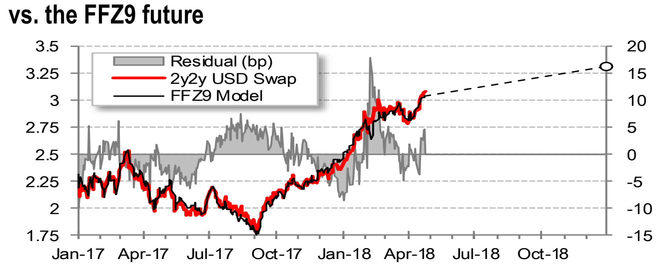
As regards the front end, we continue to think the risks remain clearly more asymmetrical as short-term rates underestimate the number of hikes suggested by the Fed. We believe the room for repricing is ample and clearly higher than the adverse negative roll-down of being short in the forward space. Therefore, we maintain our call to pay the 2y2y USD swap rate as a medium-term, strategical positioning – as we think it could end the year at around the 3.30% level if FF rates follow the path depicted in the latest FOMC dot plot (see Charts 23 and 24). This is a trade we first recommended in our September 2017 I&E, when the 2y2y rate was trading at 2.10% (for comparison purposes that position would now be approximately equivalent to a 1.5y2y, which stands at 3.05%). We then refreshed the trade and set new targets in our 22 March MMD, when the 2y2y was at 2.96%. Now, at 3.08%, the trade is again in the money and we keep it open, expecting another 20bp increase in the months to come.

Chart 23: 2y2y USD swap rate vs. FFZ9 future – Linear regression since January 2017



Source: Bloomberg, Santander.

Chart 24: 2y2y USD model based on the historical correlation vs. the FFZ9 future



Source: Bloomberg, Santander.

Euro zone Economic Outlook

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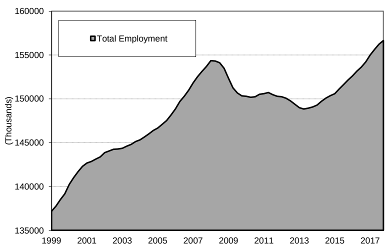
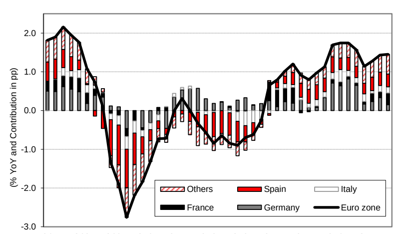
The Euro zone labour market is not only reinforcing a clear scenario of recovery but also entering a new phase of consolidation, including increasing upward pressure on salaries. In our view, this represents a change in the risks for inflation that should be incorporated in the ECB's statement progressively.

Chart 25: Total employment



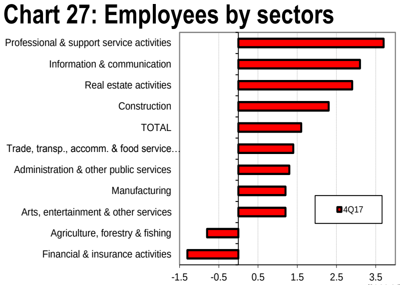
Source: Eurostat, Santander.

Chart 26: Change in total employment and national contributions



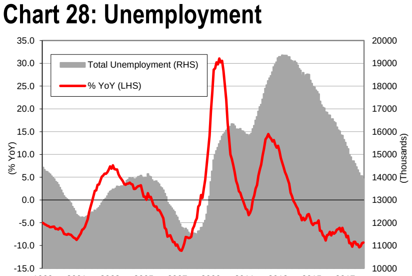
Source: Eurostat, Santander.

Chart 27: Employees by sectors



Source: Eurostat, Santander.

Chart 28: Unemployment



Source: Eurostat, Santander

Evident labour market recovery towards a new consolidation phase

The encouraging trend depicted by the Euro zone labour market in 2017 is clearly seeing some continuity at the beginning of 2018, even with some positive surprises and, at the end of the day, supporting households' confidence and spending.

In fact, total employment is at a record high and even seems to be gaining some traction again, at 1.6% YoY in 4Q17 versus 1.3% YoY in 2016, thanks to the generalized positive contribution from all the Euro zone member countries. Importantly, this upward trend in employment is the result of generalized job creation in all the main productive activities, with the exception of agriculture, forestry & fishing (at -0.8% YoY in 4Q17) and financial & insurance activities (at -1.3% YoY). In this context, we highlight the strong job creation in professional & support services (3.7% YoY in 4Q17), information & communication (3.1% YoY) and real estate (2.9% YoY) activities. At the end of the day, the pace of employment creation in the region is solid and widespread.

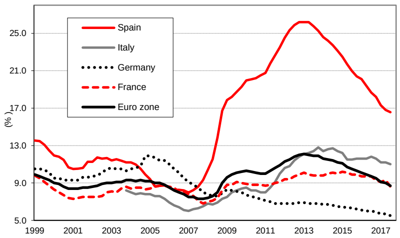
As expected, this encouraging performance of employment has resulted in a significant fall in total Euro zone unemployment, with a downward trend that includes a rate close to -10.0% YoY. Indeed, total job-seekers amounted to 13.916 million people in the whole area in February 2018 and the unemployment rate fell to 8.5% that month, which is its lowest since December 2008. It should be noted that this decline in the unemployment rate is also generalized among all the age groups, something that, in our view, raises the potential positive impact on people's propensity to spend.

Additionally, this important improvement in the conditions for the area's labour market is attracting immigration into the Euro zone again, mainly in the age group defined as active population. In fact, for the whole Euro zone, active population from foreign countries is increasing by c4.0% YoY, highlighting the significant take-off in the Spanish case (also slightly above 4.0% YoY from -11.4% YoY in 1Q14). This performance could have significant implications for the economies' potential growth and the pace of unemployment reduction, in particular in countries with a net negative domestic demographic trend. In any case, it evidences a qualitative improvement in the labour market recovery.

Furthermore, the participation rate in the whole Euro zone continues rising, at 73.3% in 4Q17, an upward trend that is mainly explained by the massive incorporation of women into the labour market. In this segment, the participation rate rose to 68.0% in 4Q17 from 61.5% in 1Q05. In addition, this increase in women's participation rates is boosting their employment rates thanks to the growing likelihood of finding a job.

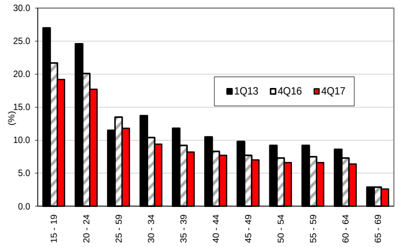
Lastly, households' perception on progress in the labour market is also quite significant. In fact, consumers' expectations about unemployment in the next 12 months are at around their historical lows and, with the consequent positive impact on their outlook about their financial and economic situations, close to 1.0 and 2.0 standard deviations above their average, respectively. In other words, households anticipate that more is to come, which could reduce their propensity to save.

Chart 29: Unemployment rate



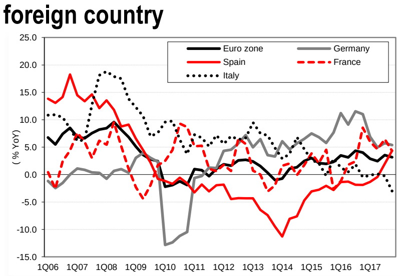
Source: Eurostat, Santander.

Chart 30: Unemployment rate by age group



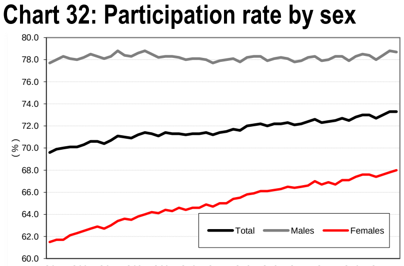
Source: Eurostat, Santander.

Chart 31: Active population from foreign country



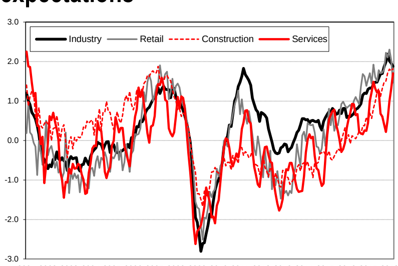
Source: Eurostat, Santander.

Chart 32: Participation rate by sex



Source: Eurostat, Santander.

Chart 33: Companies' employment expectations



Source: EC, Santander.

At the end of the day, we think that it is very evident that the figures on the performance of the labour market and expectations augur promising developments in household spending. According to our estimates, Euro zone private consumption could reach 1.9% in 2018E and 2.2% in 2019E, that is, accelerating in comparison with 1.7% in 2017. This is very relevant because this item represents 56% of total GDP and is consistent with our central scenario where Euro zone GDP growth remains above 2.0% YoY in the period considered (we estimate 2.4% in 2018E and 2.2% in 2019E).

More balanced risks for growth… and also for inflation

All in all, the labour market performance is undoubtedly favourable for growth and we expect this positive trend to continue in coming quarters, even with some risks to the upside.

In this sense, the results of the companies' confidence surveys are very interesting. On the one hand, despite the upward trend depicted so far by employment in the Euro zone (remember, to a historical record high) and its member countries, in April firms continue pointing to the need for a new increase in staffing levels to cope with rising demand, which is generalized among the main sectors. This suggests a solid pace of employment generation going forward.

On the other hand and, in our view, more noteworthy, business confidence surveys suggest persistent supply constraints with an increase in backlogs of work and, importantly, some companies pointing out recruitment difficulties. This implies that, in some activities and countries, upward pressures on salaries are increasing.

In sum, the above means that, so far, the increase in households' income has mainly been driven by the pace of employment generation, while the performance of wages per employee has been more muted. That said, this could be changing, prompting a more evident translation of the employment recovery into the performance of salaries, although, in our view, this would still be limited to some specific activities and countries.

To be incorporated progressively into the ECB's message

Against this backdrop, we think the ECB's statement should be modified progressively, recognizing that risks are becoming more balanced. On the growth side, the Euro zone monetary policy authority already assesses risks as being broadly balanced, highlighting some negative factors for growth, such as rising protectionism and developments in foreign exchange and other financial markets. But, on the positive front, the ECB mentions the prevailing encouraging cyclical momentum and, in this regard, the aforementioned evolution of the labour market and its reflection on households' spending and confidence clearly reinforce this side of the equation.

In other words, the labour market's performance is a factor to monitor closely due to its implications for underlying inflation that, as cited by the ECB, is still low by historical standards. Indeed, more emphasis should be put on upward pressures on inflation coming from the cyclical momentum, ongoing reduction of labour market slack and increasing capacity utilization. In our view, the ECB's sensitivity to a change in its wording on inflation risks could have increased in a context where commodities prices in euros (oil prices included) are also rising.

Euro Rates Strategy: Shallow bear trend to continue as ECB policy discussion is still evolving

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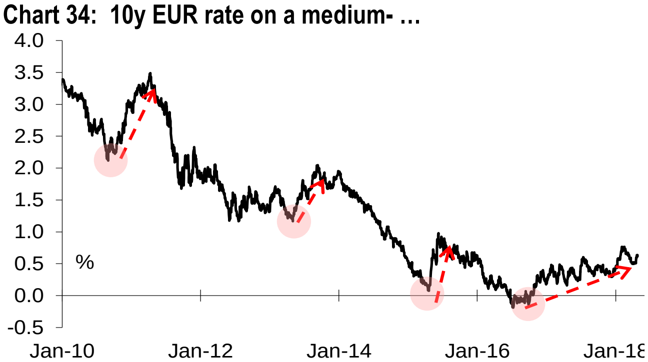
- **Euro rates remain in a shallow bearish trend. Macro data are probably still accelerating, but so slowly that ECB timing is not obvious.**
- **The transition from APP-centred to forward guidance-centred policy is net bearish, as long as the data hold up. We expect the belly of the curve to underperform.**
- **Periphery spreads are underpinned by fundamentals. Even though further convergence is likely to be limited, we find the periphery yield/volatility ratio attractive, especially in SPGBs.**

Core rates caught between ECB policy 'evolution' and moderate data

Four months into the calendar year, **both the price action and the stream of macro and policy information continue to support our expectations that Euro rates will rise though 2018 <u>but</u> at an unusually slow pace**.

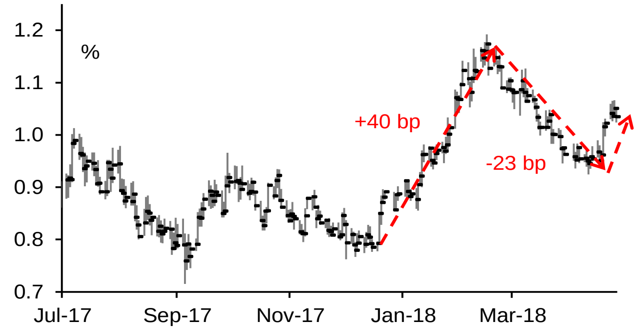
Using the bellwether 10y Euribor rate, from the all-time and cycle lows set in September 2016, rates have set a protracted series of higher highs and higher lows, which is a working definition of a bear market in fixed income. Equally, though, the pace of the overall rise has been distinctly slower than all previous sell-offs since 1999. True to that pattern, the 40 bp sell-off from last December to mid-February was followed by a **20-25 bp correction** into early April. In turn**, that move has been inverted**, with the 10y rate 10 bp above relative lows at the time of writing.

Chart 34: 10y EUR rate on a medium- …



Source: Bloomberg, Santander.

Chart 35: …and short-term perspective



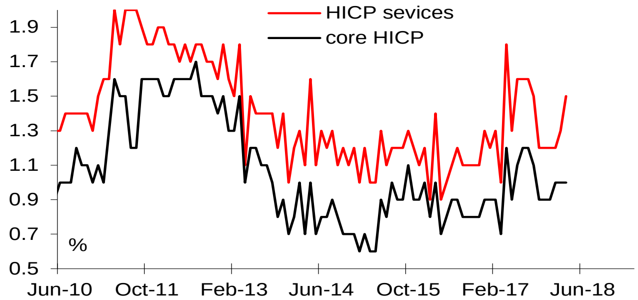
Source: Bloomberg, Santander.

That sort of price action finds some justification in the macroeconomic data, which as a whole have continued to point to **solid but low-inflation growth**.

- In terms of closing the output gap, unemployment has fallen steadily. However, in Q1 leading indicators of output like the PMI and ESI fell rather sharply. The preliminary April figures for the PMI partly support the notion that one-off effects such as extreme cold weather should wash out, in the future. However, a strong € and concerns about free trade remain in place.
- **Core HICP has been stubbornly stable around the 1% level** and the March headline figures were progressively adjusted lower with a 'final' figure of 1.3% y/y. Oil price base effects suggest acceleration in the headline y/y rate, in Q2-Q3, and service price inflation has accelerated modestly. Again, a rather mixed set of figures, with **<u>limited upside for market-traded inflation</u>**.

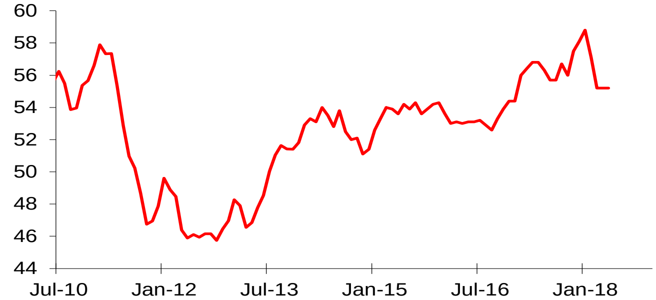
The flash HICP figure for April and final PMI data will be released after this research has been published, but we see limited prospects for a wholesale change in market views regarding Euro area nominal GDP growth, over the next few weeks. It is also not clear over what time span the US-initiated disputes over trade will reach some sort of settlement. These factors clearly cap the upside for rates, even before we take monetary policy into account.

Chart 36: Core HICP stuck but services infl. rebounds



Source: Eurostat, Santander.

Chart 37: Has composite PMI halted its slide?



Source: Reuters-Markit, Santander.

Given that positive, but fairly subdued, economic environment, the ECB, at its latest meeting, yesterday, maintained an overall dovish tone (prudence, patience, persistence). With no change in policy, the essence of the Q&A and introductory statement is that:

- **Any solid decision about the Asset Purchase Programmes** (APP) **is postponed until this summer, probably July**. The commitment to maintaining APP stock for an extended period of time after the end (of the programme) remains, however, and **it would take an (unlikely) deceleration in the macro figures for investors to abandon the consensus that the APP will be wound down quickly**.

- The format and parameters of **forward guidance** on rates, which continues to be viewed as the ECB's main policy focus once the APP ends, are **yet to be defined, leaving the market to shift rate expectations backwards and forwards** on the basis of data/news flow rather than actual ECB information.

Despite the clearly cautious ECB approach, that sort of vacuum in policy direction could mean that upward surprises on the data front could translate more fully into higher rates, especially in longer-dated tenors. Our extant macro recommendations have been aligned with that risk profile and we recap them here:

Trade idea: Euro HICP ILS steepener

Pay 10f5y EA ex-tob. ILS vs realised inflation
Receive 5y EA ex-tob. ILS vs. realised inflation

Entry level = 57 bp; current = 56 bp; target = 65 bp.

Trade idea: 5-7-20y butterfly

Pay EUR 5y and 20y
Receive EUR 7y

Entry level = 26 bp; current = 25 bp; target = 30 bp.

The long-end steepeners (such as the 10f5y – 5f5y) have shown statistical instability recently, however, and we would close them.

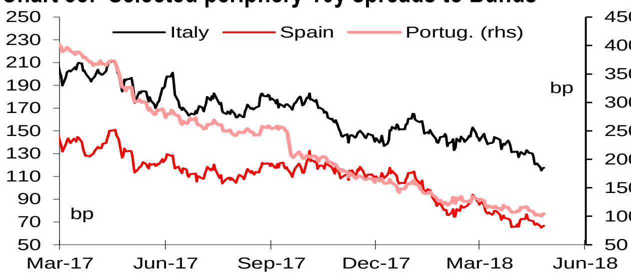
Lastly, but of significant importance, is the fact that **the Fed remains committed to further policy tightening** (see US section for details), and gradually driving USD rates higher across the curve. With USD-EUR spreads at historically high levels, that too should contribute to higher EUR rates.

Periphery EGBs benefit from broadly positive news flow

Whereas the bearish trend in underlying core EGBs has been rather stop-and-go in nature, the latest leg of the multi-year convergence dynamic between periphery and core sovereign yields has been fairly continuous. The **tightening trend has been underpinned by significant improvements in fiscal balances, ratings upgrades and evidence of structurally improved labour markets**. It is therefore tempting to conclude that the trend will remain in place in coming months. After all, investor appetite for periphery EGBs remains positive, especially among international accounts.

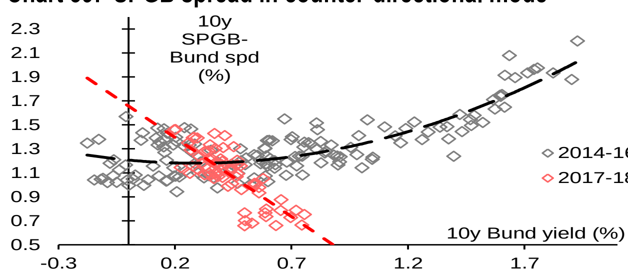
However, if we were to assume the same rate of outperformance over the next 12 months as took place over the past year, the 10y spread over Bunds would have to be 0-10 bp for SPGBs and 50 bp for BTPS. Neither level looks plausible to us, in light of the events of the past decade and the degree to which EMU cohesion remains ultimately dependent on the ECB backstop.

Chart 38: Selected periphery 10y spreads to Bunds



Source: Bloomberg, Santander.

Chart 39: SPGB spread in counter-directional mode



Source: Bloomberg, Santander.

SPGBs as low-beta, defensive EGBs

Does that mean investors should reduce periphery overweight positions? We believe that would be premature. ECB policy is still centred on maintaining lower rates (overall) than those that result without its intervention. In a macro environment of solid growth that is a boon to higher-debt and higher-structural deficit issuers. It has, of course, resulted in **several ratings upgrades** (especially for Spain and Portugal).

The **persistent monetary policy lag vs. the cycle** probably helps explain why, in the 2017-2018 period, SPGB-Bund spreads have returned to an 'inverted' relationship, whereby **higher rates result in tighter, not wider, spreads** (Chart 39). Essentially we find this has turned SPGBs into low-beta, higher-yielding bonds than core ones, with a clearly dominant Sharpe Ratio, as a result. On that basis, we still like overweight positions in periphery EGBs, overall.

The one major issuer where news flow has not been one-way positive is **Italy**, which **still faces considerable political/policy uncertainty**. Ahead of the election, we had opined that a sell-off would probably not prove lasting but, in fact, it never occurred at all. We would argue that, in the near term, this risk is under-priced.

From a relative value standpoint, one area of the Spanish term structure that has lagged, comparatively, other SPGBs is in the 15y segment of inflation-linked SPGB€i. This partly reflects expectations of supply in that segment, but we also see the yield pick-up available as quite attractive. We recently recommended this trade and still think it has a good chance of outperforming. This trade should work against Bund€i, as well as against OAT€i.

Trade idea: Inflation-linked SPGB€i – OAT€i tightening trade

Buy SPGB€i 1% Nov-2030
Sell OAT€i 0.7% Jul-2030

Entry level = 72 bp; current = 67 bp; target 60 bp

Euro government bond supply: YTD update

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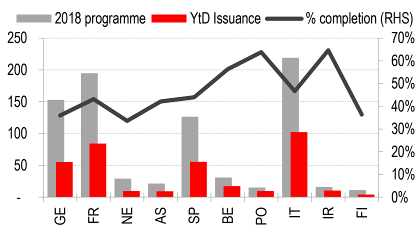
Table 3: End-of-April issuance completion

(€bn)	Auctions	Syndicates	Total
2012	272.3	43.7	316.0
2013	284.5	72.6	357.1
2014	321.6	62.1	383.6
2015	298.5	74.2	372.7
2016	262.2	74.5	336.7
2017	293.9	65.5	359.3
2018	296.9	60.0	356.9
7y average	290.0	64.6	354.6

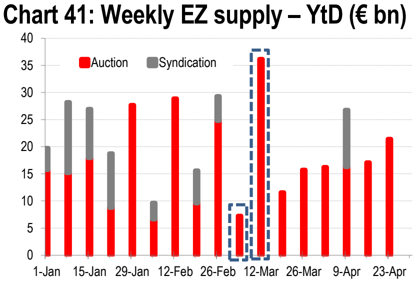
Source: Bloomberg, Santander

Chart 40: 2018 YtD issued vs. target



Source: Bloomberg

Chart 41: Weekly EZ supply – YtD (€ bn)



Source: Bloomberg

Table 5: YtD issuance completion vs. historical data

	2013	2014	2015	2016	2017	2018	Aver 13-17
GE	34%	34%	38%	35%	34%	**36%**	35%
FR	41%	44%	38%	40%	37%	**43%**	40%
NE	45%	52%	44%	30%	46%	**34%**	43%
AS	37%	22%	24%	42%	42%	**42%**	33%
SP	42%	42%	42%	39%	42%	**44%**	41%
BE	47%	53%	43%	52%	51%	**56%**	49%
PO	45%	41%	57%	57%	48%	**64%**	50%
IT	38%	42%	46%	41%	40%	**47%**	41%
IR	100%	49%	72%	57%	49%	**65%**	65%
FI	37%	33%	43%	56%	54%	**36%**	45%
TOTAL EZ (€)	**40%**	**41%**	**42%**	**40%**	**40%**	**44%**	**41%**

Source: Bloomberg. YtD (calendar year) data for 2018. Jan-Apr aggregates for historical data.

2018 EUR govie issuance nears the 45% mark

At the end of April, the Eurozone as a whole will have covered c.44% of its total average govie financing needs for 2018, having sold more than €355bn of bonds (of the €817bn total) via both ordinary auctions (€270bn), including second-round allotments, and syndicated deals (€60bn). According to our numbers (Table 3), due to the stable market conditions and the ECB's EAPP approaching an end, EUR issuers have been issuing as aggressively this year as in 2017, mirroring the levels seen in 2013 right after the beginning of the financial crisis. Perhaps, this signals a stabilization of the issuance pace (auctions and syndicates), as the average of the last seven years stands at c.€355bn in the first four months of the year, as seen in Table 3.

In terms of weekly averages, Eurozone issuance stood at €21bn at the end of April. As shown in Chart 41, the second week of March (commencing 12 March) still marked the largest volume of supply, with €36.2bn placed, including syndications, whereas the week before (that starting 5 March) saw the lowest volume, at just €7.2bn.

Table 4 shows that, as at 27 April, Italy is at the forefront in terms of YTD issuance, with €102.1bn, becoming the first of the four biggest EUR issuers to surpass the €100bn mark. France, with €84.1bn, is second, Spain comes in third, with €55.5bn, and Germany is a very close fourth, with €55bn. Belgium is well behind, having issued just €17.5bn so far, followed by Ireland (€10.3bn), the Netherlands (€9.7bn), Portugal (€9.6bn) and Austria (€9.1bn). Lastly, Ireland (€4bn) is at the tail end of the ranking.

Table 4: Total issued in EZ in 2018, by country (updated as at 27 April)

	GE	FR	NE	AS	SP	BE	PO	IT	IR	FI	TOTAL EZ (€bn)
YtD auctioned issuance	55.0	80.6	9.7	5.1	39.5	8.0	2.6	93.1	2.3	1.0	296.9
YtD syndicated issuance	0.0	3.5	0.0	4.0	16.0	9.5	7.0	9.0	8.0	3.0	60.0
YtD Issuance	55.0	84.1	9.7	9.1	55.5	17.5	9.6	102.1	10.3	4.0	356.9
2018 programme	153.0	195.0	29.0	21.5	126.3	31.0	15.0	219.0	16.0	11.0	816.9
% completion (RHS)	36%	43%	34%	42%	44%	56%	64%	47%	65%	36%	43.7%

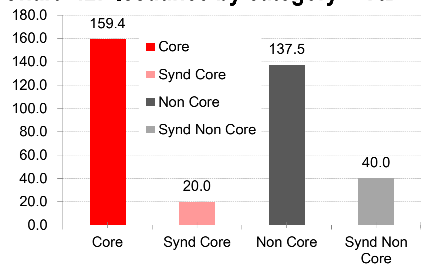
Source: Bloomberg, Treasury Agencies

In terms of YTD completion rates by country, Ireland and Portugal are above the 60% mark as regards their progress towards the 2018 issuance targets and lead the Euro area issuer ranking (at 65% and 64%, respectively). Belgium has passed the 50% mark, placing it in third place, at 56%. Italy (47%), Spain (44%), France (43%) and Austria (42%), in that order, have also joined the 40%-plus club. Germany and Finland are tied at 36%, while the Netherlands comes last, with 34% (see Table 4 for details).

As shown in Table 5, Portugal, Belgium, Italy and Spain have set new record highs for the last five years in terms of bond issuance completion at this point of the year, at 64%, 56%, 47% and 44%, respectively, pushing the region's combined issuance pace to a new record high, too (44%). The rest of the EUR issuers are selling debt within their maximum-minimum ranges over the last five years.

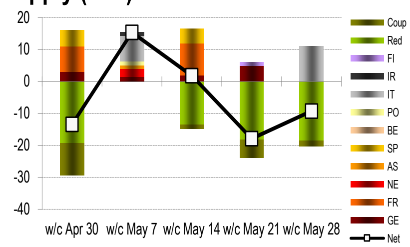
Compared with the 2017 completion rates (see Table 5) at this point of the year, Portugal and Ireland are tied in first place, exceeding last year's average by 16pp. Italy is next, having completed 7pp more than in 2017. France and Belgium outstrip last year's average by 6pp each, placing them joint fourth. The rest, bar Finland (-18pp) and the Netherlands (-12pp), have been issuing slightly faster, or around the same pace, YTD as at this point in 2017.

Chart 42: Issuance by category – YtD



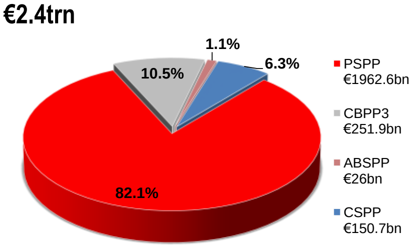
Source: Bloomberg

Chart 43: Expected EUR bond net supply (€bn)



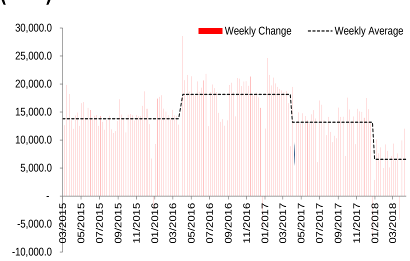
Source: Bloomberg

Chart 44: The ECB's EAPP portfolio: €2.4trn



Source: ECB, Bloomberg, Santander

Chart 45: The ECB's EAPP portfolio: weekly change vs. weekly average (€bn)



Source: ECB, Bloomberg, Santander

Core countries still issuing more than periphery ones

Total core (and semi-core) supply (Germany, the Netherlands, France, Belgium, Austria and Finland) surpasses that from the non-core bloc (Italy, Spain, Ireland and Portugal) at the end of April. Core issuance accounts for 50.3% of the total, the equivalent of €179.4bn, while periphery supply makes up the remaining 49.7%, or €177.5bn.

The core countries have auctioned 1.16x more than the periphery (€159.4bn vs. €137.5bn) so far in 2018. In syndicated deals, however, the non-cores have placed two times more than their core counterparts (€40bn vs. €20bn).

Supply dynamics: negative net EUR supply for the next five weeks

The next five weeks see more than €65bn issued via auctions (not counting syndicated deals). On our numbers, Italy should place €19b (not counting the BTP Italia to be launched on 14 May), France €18bn, Germany €12bn and Spain around €10bn. The Netherlands plans to reopen its 10y DSLs for up to €2.5bn, while Austria and Portugal are together scheduled to sell an estimated €2.5bn. Ireland and Finland could sell around €1bn each, while Belgium takes a break in May. All this supply will basically be offset by redemptions (€70bn) and coupon payments (€19bn). Consequently, net EUR issuance will stay very negative over the next five weeks (Chart 43).

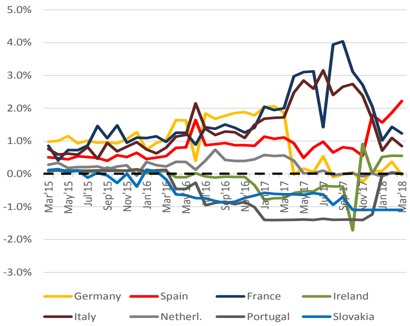
Update of the ECB's PSPP

On 23 April, the ECB published the latest figures for its Extended Asset Purchase Programme (EAPP) holdings, which include the purchases settled as at 20 April. According to the latest report, its holdings now stand at €1.96trn in the **PSPP**, €252bn in the **CBPP3**, c.€151bn in the **CSPP** and €26bn in the **ABSPP**, for a total EAPP portfolio of €2.4trn. According to the overall figures, the pace of ECB asset purchases slowed down significantly in the third week of April (to €47mn from €12bn the previous week) with overall buying decelerating into the fourth month of the EAPP's €30bn-per-month scheme.

The latest information available by country is the ECB's breakdown of its PSPP debt security holdings published on 4 April (for details, see our 5 April MMD). The March figures show that public sector purchases totalled €20.8bn, €18.7bn of which were euro-denominated public sector debt (slightly below the February figures) and the rest supranational debt (€2.1bn). And we expect these numbers to remain around these levels until the end of September, when the ECB is expected to scale back its monthly purchases from €30bn to €10bn, on our estimates, for the reminder of the year. As shown in Table 6 on the following page, the March numbers show that the country breakdown saw decreases across the board, with the exceptions of Lithuania, Malta, and Luxembourg. Note that the ECB continued to concentrate its purchases in Germany, France, Italy and Spain, where the monthly purchases were the largest (€14.9bn of the €20.8bn PSPP total in March).

In terms of duration, March saw a slight decrease in the purchases' total average remaining maturity. The aggregate for March (11.7 years) is 0.7 years less than in February (12.4 years), but 1.97 years more than the last 12-month average (9.73 years). The March purchases were significantly skewed to the short end in Latvia, Malta, Austria, Germany and Austria, among others, but not in Lithuania, Slovenia, Belgium or Ireland, which saw large increases in maturity. Lastly, supranational debt saw its average duration retreat by almost three years (2.45 years) to 13.97 years, somewhat above its 12-month average (12.22 years).

Chart 46: Divergences from ECB's Capital Key since March 2015



Source: ECB, Bloomberg, Santander

As regards the ECB's capital key purchase deviation, we continue to see divergence from the amount the ECB (or its national counterparts) is supposed to buy from each country. As seen in Chart 46, the most negative cases are those of Slovakia and Slovenia. To a lesser extent, we find Finland, among others, perhaps caused by the lack of supply in the market. At the other extreme, the divergences for Spain and France are above the 1% mark (the Spanish share is slightly above the 2% level), followed by Italy and Ireland, indicating that the ECB (or the national central banks) is purchasing beyond the capital limits.

As we enter the last phase (for now) of the EAPP, the ECB's monthly purchases now stand at €30bn/month for the remainder of the programme, that is, until September this year (as the ECB stated at its December 2017 meeting). Afterwards, we estimate that the ECB could buy around €10bn/month under the EAPP (72% of which could be directed to the monthly PSPP amount, based on the historical average since January 2018) during the last three months of the year. And, with the CSPP, we believe the ECB will earmark 18% per month to buy corporate bonds, 9% for covered bonds and the remaining 1% for ABS, the same proportions as seen since the beginning of this year.

Table 6: The ECB's PSPP purchases - Country breakdown

Holdings (€mn)	1Q15 (Mar' 15)	2Q15	3Q15	4Q15	1Q16	2Q16	3Q16	4Q16	1Q17	2Q17	3Q17	4Q17	Jan'18	Feb'18	Mar'18	Monthly Change	Monthly Avge	2015 Purchases	2016 Purchases	2017 Purchases	2018 Purchases	Total Purchases
Austria	1,215	3,828	3,706	3,890	4,060	6,049	5,116	5,334	5,816	4,548	4,213	4,184	549	584	552	-32	1,450	12,639	20,559	18,761	1,685	53,645
Belgium	1,527	4,843	4,637	4,888	5,126	7,648	6,449	6,716	7,257	5,739	5,321	5,313	713	757	714	-43	1,828	15,895	25,939	23,630	2,184	67,648
Cyprus	-	-	98	187	-16	-	-21	-	-	-34	-1	-	-	-	-	0	6	285	-37	-35	-	214
Germany	11,063	35,262	33,752	35,541	37,198	55,446	46,803	48,874	51,650	36,301	33,648	33,773	4,823	5,078	4,765	-313	12,810	115,618	188,321	155,372	14,666	473,983
Estonia	-	5	33	10	13	5	-	-	-	-	-	-	-	-	-	-	2	48	18	-	-	65
Spain	5,444	17,294	16,562	17,513	18,343	28,175	23,052	23,944	25,615	18,844	17,509	17,962	2,655	2,824	2,758	-66	6,446	56,813	93,514	79,930	8,237	238,498
Finland	774	2,463	2,362	2,487	2,615	3,914	3,280	3,403	2,233	1,953	1,384	2,302	280	296	280	-16	812	8,086	13,212	7,872	856	30,021
France	8,752	27,535	27,037	28,438	29,810	44,014	36,947	38,329	41,505	32,871	30,374	30,151	3,978	4,224	3,990	-234	10,485	91,762	149,100	134,901	12,192	387,961
Ireland	721	2,293	2,234	2,333	2,393	3,275	2,665	2,649	1,669	1,556	1,664	1,830	407	431	410	-21	717	7,581	10,982	6,719	1,248	26,528
Italy	7,604	23,977	23,201	24,422	25,588	39,212	32,151	33,447	35,977	28,503	26,484	26,156	3,421	3,638	3,422	-216	9,114	79,204	130,398	117,120	10,481	337,208
Lithuania	39	339	394	335	343	322	193	299	210	147	92	191	72	-201	3	204	75	1,107	1,157	640	-126	2,778
Luxembourg	183	550	304	78	423	77	16	112	151	186	163	142	27	25	27	2	67	1,115	628	642	79	2,464
Latvia	75	429	64	117	115	224	144	145	160	106	80	84	54	47	-59	-106	48	685	628	430	42	1,785
Malta	5	204	53	20	141	163	30	191	108	41	59	12	7	5	31	26	29	282	525	220	43	1,070
Netherl.	2,486	7,858	7,473	7,795	8,393	12,360	10,591	10,868	11,715	8,269	7,471	7,504	1,055	1,123	1,063	-60	2,866	25,612	42,212	34,959	3,241	106,024
Portugal	1,073	3,422	3,274	3,450	3,624	4,294	2,702	2,770	2,007	1,528	1,425	1,493	461	489	462	-27	878	11,219	13,390	6,453	1,412	32,476
Slovenia	209	679	651	690	769	732	595	609	462	391	466	655	108	115	109	-6	196	2,229	2,705	1,974	332	7,239
Slovakia	506	1,597	1,332	1,187	1,562	885	477	610	929	681	458	559	187	141	137	-4	304	4,622	3,534	2,627	465	11,248
Sub Govies	**41,676**	**132,578**	**127,165**	**133,383**	**140,511**	**206,793**	**171,192**	**178,298**	**187,462**	**141,631**	**130,809**	**132,311**	**18,798**	**19,576**	**18,665**	**-911**	**48,131**	**434,802**	**696,794**	**592,213**	**57,039**	**1,780,855**
Supras	5,680	18,187	18,028	18,206	18,871	23,451	18,951	19,853	20,922	15,777	14,700	14,794	2,107	2,225	2,109	-116	5,780	60,101	81,126	66,193	6,441	213,863
TOTAL PSPP	**47,356**	**150,765**	**145,193**	**151,589**	**159,382**	**230,244**	**190,143**	**198,151**	**208,384**	**157,408**	**145,509**	**147,105**	**20,905**	**21,801**	**20,774**	**-1,027**	**53,911**	**494,903**	**777,920**	**658,406**	**63,480**	**1,994,718**

Source: ECB, Santander

UK Economic Outlook

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- **Bank of England Governor's latest comments have left markets uncertain of a May interest rate hike from the Bank…**
- **…but we continue to believe that monetary policy will remain on hold through the remainder of 2018 and 2019**
- **We believe that the Governor's communication provided important insights into the Committee's views on both growth and inflation…**
- **…while a more direct, explicit link was apparent between the path of monetary policy and the outcome of the Brexit negotiations.**

UK Monetary Policy: Definitely maybe, not definitely May

Bank of England Governor Mark Carney's interview with the BBC on 19 April struck a much more balanced tone than other recent Monetary Policy Committee (MPC) communications, and has led the market to re-appraise the outlook for a May interest rate hike from the Bank. A roughly 85% probability of a May move by the MPC had been implied by market pricing prior to the Governor's latest intervention, even as, in our view, the recent UK activity and inflation data have displayed an increasingly weak underlying trend. Market pricing of a May UK rate hike has now typically moved towards the 50% level. But, with the Governor still stressing the likelihood of a rate hike emerging in 2018 –albeit with more conditionality attached than most investors had previously believed– Mr Carney's intervention has so far worked to alter the expected profile of monetary tightening, rather than the direction of policy overall.

However, with growth struggling to regain momentum, wage growth failing to convince and inflation falling fast, we remain comfortable with our view that UK monetary policy will stay on hold through 2018 and 2019. Ultimately, we have argued that the window of opportunity for a UK rate hike would close as 2018 progressed and, with this latest commentary from the Governor suggesting that the Committee may still not be convinced by the need for early action, we think that this process is now well underway.

Indeed, we believe that several aspects of Mr Carney's comments suggest that a 2018 rate hike is perhaps still less certain than even the corrected market pricing now implies. We believe the main conclusions that can be drawn from the Governor's latest communications are as follows:

1) **MPC likely regards guidance as flexible, not exact:**

We argue that the first conclusion which can be drawn following Governor Carney's latest comments actually relates to the issue of the MPC's own policy guidance and communications, which we believe the market had previously –and erroneously in our view– regarded as signalling a strong commitment to a May interest rate hike.

At the February Inflation Report press conference, of course, Governor Carney suggested that it would "likely be necessary to raise interest rates to a limited degree, in a gradual process, but somewhat earlier and to a somewhat greater extent than we had thought in November (2017)". In response, the implied probability of a (25bp) rate hike occurring at the 10 May MPC meeting immediately jumped to, and remained close to, the 80% level (or above), until the Governor's latest comments emerged after market close on 19 April.

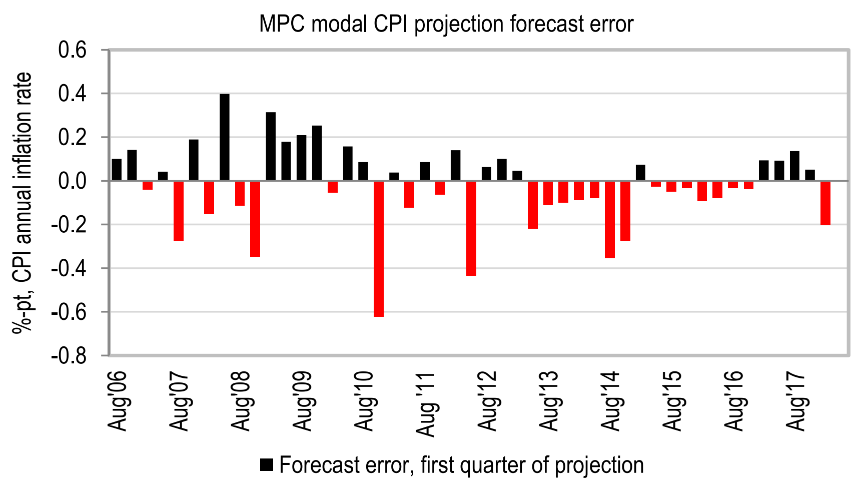
In the aftermath of the February Inflation Report (please see 'That was then, this is now', published 9 February), we argued that the MPC's commentary –in our view a form of 'backward guidance'– risked confusion, and threatened a further, eventual re-pricing of the interest rate outlook for the UK. We stated that the MPC's choice of reference point failed to recognise both the shift in rate expectations that had already occurred following the November 2017 Inflation Report, and how this move in the market interest rate profile was likely to influence the evolution of both growth and inflation over the MPC's forecast horizon.

But, in a literal sense, the Governor could still argue that the guidance provided in February has not been broken by his latest commentary, given that the interest rate profile used to produce the November 2017 Inflation Report implied only two 25bp rate hikes over a three-year horizon, with the first emerging in late-2018 or early-2019. Rather than helping to identify the exact point of any changes in monetary policy, the MPC's communication may instead be aimed simply at signalling broad intentions around the possible timing and extent of policy moves, whilst also retaining the right to alter such commentary as the outlook for growth and inflation evolves.

2) Balance of external domestic price pressures now more doubtful:

In line with this rationale, we believe that the Governor's latest comments are also likely to have been motivated by the decline in the headline rate of CPI inflation to just 2.5% in March and, more significantly, by an increased degree of uncertainty around the likely balance between exchange rate-related and domestically-generated price pressures over the Committee's forecast horizon.

Chart 47: Bank of England Inflation Report CPI forecast errors



Source: Bank of England, ONS, Santander.
Note: Chart shows the difference between the Inflation Report CPI projection for the first quarter of the MPC's forecast period (i.e. Q1-18 for the February 2018 Inflation Report) and the actual outturn. Data are shown so that a weaker-than-expected outturn is presented as a negative value.

As we highlighted in our recent analysis of the March 2018 consumer price data (please see '[Big fall; Bigger changes required by the MPC]', released 18 April), UK CPI inflation averaged 2.72% in Q1-18, versus the 2.92% forecast contained in the February 2018 Inflation Report. On this very short-term horizon, we calculate this 20bp differential to be the largest CPI forecast error from the MPC since November 2014 (see Chart 47), and argue that this shortfall reflects exchange rate-related inflationary pressures falling at a much faster pace than policymakers appear to have expected, while domestically-generated price growth has also remained subdued. We calculate that the inflation rate of those goods and services with an estimated, direct import intensity of 30% or greater has now fallen from 3.65% in October 2017 to just 2.32% in March 2018, reducing headline CPI by 35bp in the process. And this directly challenges the MPC's assumption of a prolonged influence from the earlier decline of the sterling exchange rate.

Rather than simply representing a volatile data series or any unanticipated strength of commodity prices, therefore, we believe that the weaker CPI outturn in Q1-18 presents a fundamental challenge to the MPC's assumptions around inflation. In turn, we argue that a more fundamental overhaul of the Bank of England's CPI projections is now required in the upcoming May Inflation Report, particularly with the three-month annualised pace of regular private sector pay growth falling again in February, to just 2.5%, from the 3.3% pace seen in November 2017. Put simply, we see little within either the service sector elements of the CPI, or wage growth more generally, to suggest that an acceleration of domestically-generated inflation is about to offset the sharp fall in exchange rate-related price growth. Hence, we expect lower CPI projections to feature in the May Inflation Report.

3) Activity data have disappointed, regardless of the weather:

Alongside the weakness of the inflation and wage data, we believe that the Governor's more measured tone likely reflects a growing level of concern around the strength of UK activity data, with the extent to which this recent softness reflects a temporary, weather-related disruption likely to prove a contentious issue across the Committee.

Already, external MPC member Michael Saunders –typically viewed as the most hawkish individual on the Committee– has argued that the current profile of UK activity releases is compatible with that seen around other substantial weather disruptions experienced over the past two decades. In his latest speech, Mr Saunders argued that such weather events typically lead to a measure of monthly GDP –calculated as a weighted measure of industrial production, services and construction output–falling by 0.3% during the affected month, with a recovery of a similar magnitude then developing in the following month.

However, we believe that several aspects of the recent UK survey data –in particular, the sharp decline in the business expectations component of the March services PMI, and the failure of the CBI Industrial Trends survey to recover in April– questions such an analysis of the current situation. With retail sales volumes (on an ex-auto fuel basis) falling by 0.4% in Q1-18, following on from a gain of just 0.2% in Q4-17, and construction output slipping by 3% in the year to February, we believe that any attempt to attribute the poor UK data to weather effects risks ignoring the persistence of the weakness on display across many indicators. Indeed, absent the enduring strength of employment growth, we believe that the focus of market speculation could conceivably relate more to the direction of the next move in Bank Rate, rather than the precise timing of any future hike.

4) Brexit negotiations now an explicit influence on monetary policy:

We argue that one final, notable feature of the Governor's latest comments related to the ongoing Brexit negotiations, with Mr Carney making a more explicit link to the outcome of the Article 50 process and the future path of monetary policy. Previously, the Committee had appeared content to view UK government policy on Brexit as a given, and refused to discuss how this may impact monetary policy. But the Governor's comments appear to have drawn a more direct connection between the two issues, with uncertainty around the Brexit negotiations being highlighted as a further potential reason to defer key interest rate decisions.

In our recent research publication, 'Lost in transition?' (published 6 March 2018), we questioned whether the uncertainty around the ability of the UK government to secure a transition deal with the EU for the post-2019 period –in turn contingent upon a broader Withdrawal Agreement being achieved– may influence the path of monetary policy in the UK. We outlined how the UK government's stated intention to eventually leave the Customs Union upon exiting the EU –and the potential problems created for the Irish land border– had led the EU to outline a fall-back scenario that would see the UK government effectively ceding control over Northern Ireland's customs arrangements, immigration policy, environmental and product standards, competition and State aid law, as well as its agriculture and fisheries policies. Ultimately, we questioned the ability to move towards a compromise agreement on these issues through the summer months, and we believe that a rising appreciation of these difficulties is now encouraging speculation of the potential for Parliament to force a change of direction upon the UK government, and explore instead the scope to remain within the EU Customs Union. However, with visibility around this issue likely to emerge only very slowly, in our view, we believe that the Article 50 negotiations will probably present a continued constraint on the MPC's actions through 2018 and beyond.

UK Rates Strategy: The BoE’s penny has further to drop

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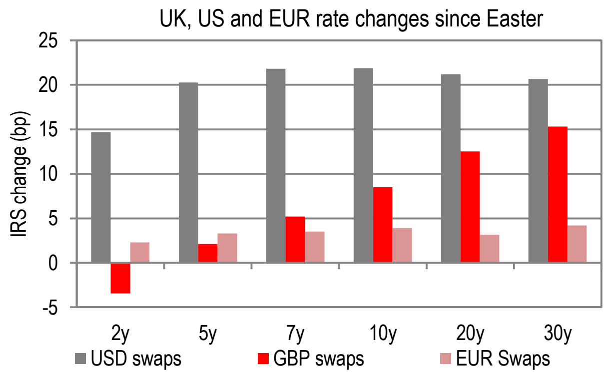
- **UK rates have continued to take directional cues from USD and EUR markets**
- **The evolving supply environment has helped gilts to steepen…**
- **…exacerbated by Carney's latest warning on monetary policy, and the accompanying deterioration in UK economic data**
- **We believe this steepening has much further to go, in both rate and spread curves and reiterate our existing trade ideas**

Even Governor Carney cannot stem the global rising tide

UK rates could not escape this month’s backdrop of a resumed bearish trend in US and, to more recently, Eurozone rates. The long end came under additional pressure in the UK, relative to more parallel moves elsewhere, as supply dynamics flipped from BoE reinvestments to an approaching ultra-long syndication. Front-end rates also experienced a UK-specific monetary policy effect, in the opposite direction, giving the whole curve a strong steepening profile not seen elsewhere (Chart 48).

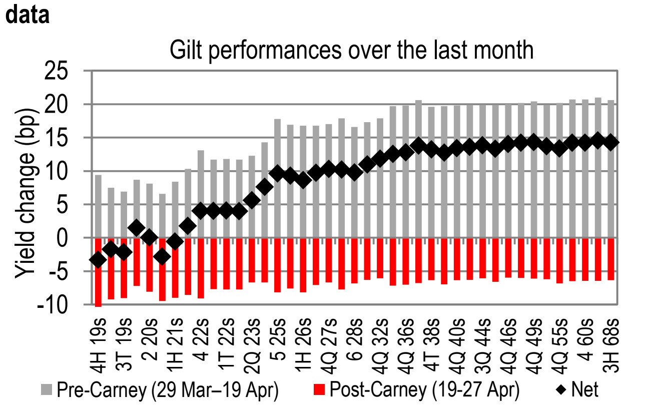
The UK rates market initially exhibited remarkably low sensitivity to the material downside surprises in the March inflation data (which we discussed here), which appears to have prompted Carney’s intervention the following day (examined here). But even the Governor’s comments only caused a focused correction in the front end: of the 11bp sell-off in 10y gilts seen on Thursday, 19 April, prior to his comments, only 4bp was reversed the next day and rates were left volatile but directionless at the start of this week. UK rates then took a more persistent and broad-based hit after the first estimate of 1Q18 GDP came in weaker than expected, at 0.1% QoQ, and –most importantly– the ONS emphasised that the slowdown was in large part NOT due to disruptive weather. This made for April rates moves that can be split into two contrasting stages (Chart 49).

Chart 48: The UK has shared the bearish direction of other markets during April, but with additional steepening from domestic monetary policy and supply factors



Source: Bloomberg, Santander. Changes from 29 March – 27 April.

Chart 49: Carney’s comments were followed by an intensification of the curve steepening, and the outright rises in yield levels earlier in the month then took a blow after the GDP data



Source: Bloomberg, Santander.

Further steepening is now our core view on UK rates

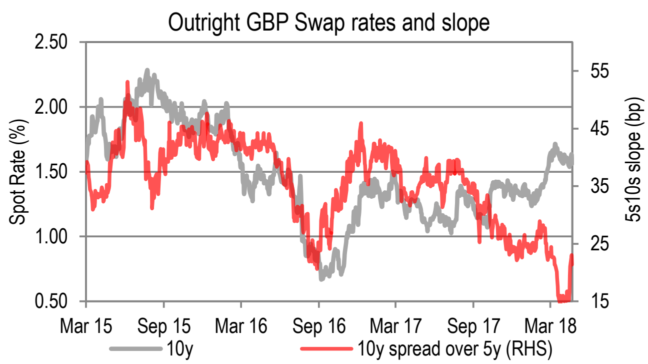
We have been anticipating a re-steepening of the UK curves for some time, recommending 5s10s (IRS) steepeners on 15 December and highlighting extra value on the gilt side through an ASW box steepener on 9 January (specifically, 1T 22s/1Q 27s). The swap expression is now marginally in profit but the ASW box 2bp offside, so we find the spread box particularly appealing at current levels. Looking at recent RV developments in these sectors, we believe the optimum gilt or gilt spread expression would currently be 0H 22s/4Q 27s for investors looking to enter steepeners now (Chart 51).

The UK curves took a major flattening hit in March, with several contributing factors: flattening in other markets, fiscal year-end positioning/unwinding and the lack of guidance from the March MPC meeting. Most of this damage has now unwound, helped by the UK supply backdrop flipping from APF reinvestments to an impending 2070+ gilt syndication. But the correction so far has been fairly limited, and we expect this steepening momentum to continue (Chart 50).

We also suggested 1s5s OIS steepeners at the start of March, on more explicit monetary policy re-profiling expectations. This is now 2.5bp onside, but still 8bp short of our 50bp target. These tenors should be more directly exposed to the dovish shift seemingly in progress among the MPC, but with more protection from a reacceleration of economies (and interest rates) elsewhere than outright long positions in short GPB rates.

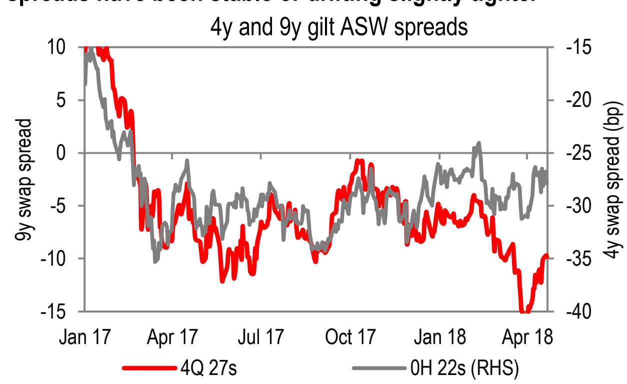
We still like all these steepening trades, and the recent high correlations between curve segments make the optimal tenor (and instrument) a relatively minor consideration, in our view.

Chart 50: Despite the latest rebound, the 5s10s curve remains extremely flat for the (familiar) outright level of rates



Source: Bloomberg, Santander.

Chart 51: 10y gilt spreads remain at their widest for some time, even after reversing their fiscal year-end boost, while 4-5y spreads have been stable or drifting slightly tighter



Source: Bloomberg, Santander.

As set out in the UK Economics section of this report, above, we are increasingly confident that the MPC will not raise Bank Rate at the May meeting. Even if the members deliver a 'hawkish hold', we believe this will drain further hike pricing from the coming year –the market still implies a Bank Rate hike by November, by which point we forecast CPI to be below target, and a second by August 2019– keeping the front end of the curve well-anchored while global momentum picks up again and takes longer-tenor UK rates with it.

We are relatively neutral on the outright direction of UK rates, and expect the main drivers to remain macro data and risk appetite coming from developments in the US and Eurozone. We see GBP rates as perhaps a little high on a cross-market basis, even after their post-GDP dip. Risks appear slightly biased to the downside if the worrying signals around Q1 activity prove deep-seated and persistent, rather than weather-related, but not unambiguously so. The coming week's PMIs will be an important test here, moving the focus from Q1 to the present, and early signs from other surveys are not encouraging.

Gilt swap spreads exhibit limited (and inconsistent) directionality with outright yield levels, so we see the ASW box as adding some additional relative value. Gilt ASW versus Libor have had a widening bias recently, but we find much of this can be attributed to FRA-OIS basis widening: the 4Q 27s' 5bp of (Libor) spread widening since yields peaked on 14 February turns into 3bp of tightening against Sonia OIS.

We have commented on the basis flattening pressures from the slow-burning transition from Libor to Sonia on many occasions, most recently in the last I&E,

and expect this trend to remain in place for some time. In the short end, we see the endurance or reversal of the considerable outright basis widening so far this year as hinging on the fate of the even more extreme move in the US.

Whichever reference rate is used, the 10y region of the gilt spread curve has outperformed its neighbours, specifically the CTD 4Q 27s. For us, this suggests the liquidity of the gilt future is important and, in turn, that the forces behind it may be fast money-oriented and prone to an equally fast reversal.

For investors who are less convinced about the steepening trend, or already have sufficient exposure, the 10y spread outperformance has also pushed the 10s20s box rather steep relative to the very flat backdrop, so we think a 27s/37s ASW box flattener would provide exposure to the richness of the CTD with an opposite curve play.

Re-expressing this view from the perspective of ‘long-only’ gilt ASW buyers, we see greater room for gilts to perform to either side of the 27s: 25s and shorter, or 32s-37s. Of these alternatives, the extension looks more attractive but is prohibited by many such investors’ 10y-max mandates – which may explain why this opportunity has arisen in the first place.

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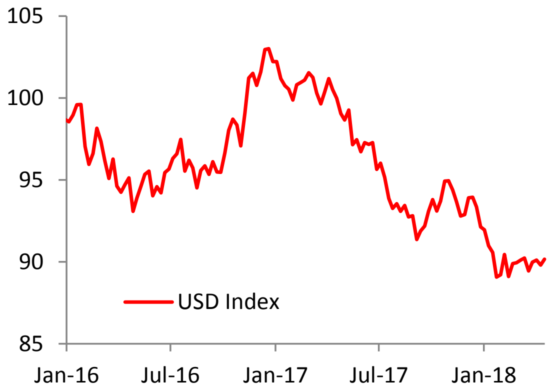
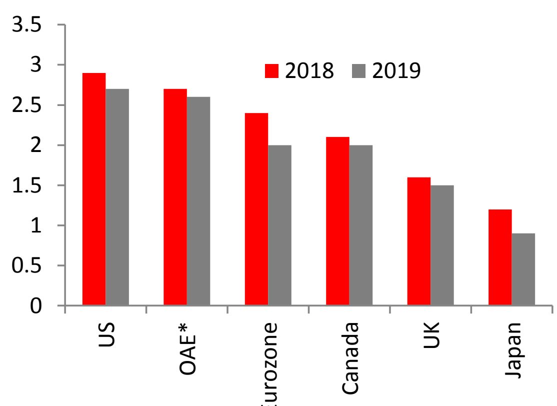
Chart 52: USD index having a more stable 2018



Source: Bloomberg, Santander

Chart 53: IMF 2018 and 2018 GDP forecasts - US expected to continue to lead the way



*Other Advanced Economies excludes the Group of Seven (Canada, France, Germany, Italy, Japan, UK, US) and Eurozone countries.

Source: IMF

USD – Steady now

The USD remains weak, but has been more stable since the start of February. Concerns over protectionist US trade policy remains a downside risk, but strong fundamentals and expected further Fed rate hikes may now be able to provide more support.

The USD remains relatively weak, but the big sell-off, which saw the USD index drop 15% between the start of 2017 and mid-February 2018, may have ended, or at least be pausing. By comparison, the index has been stable in a tight range over the last couple of months.

That said, the market's bias probably still remains to sell the USD, amid risk worries about the impact US trade policies might have on global activity. However, the short dollar trade is looking more and more satiated. Plus, recent trade rhetoric from the US government has been more mixed, e.g. indicating hope that the NAFTA negotiations will be successfully completed. Further, the push-back on US tariffs by China may be making it clear that there is less to be gained from a protectionist stance.

Plus, as noted in the EUR section, the USD should be helped by signs that the EUR may find it difficult to strengthen in the near term. The Eurozone economy should remain robust, but data have disappointed lately. Hence, the EUR may have now priced in all the good European economic news, and the EUR correction, which began after the French Presidential elections in April 2017 and helped pull the USD lower, may, for now, have run its course.

Instead, the FX market should focus more on the 'good' USD economic news. Unlike both the Eurozone and the UK, US economic data continue to surprise to the upside. Plus, the IMF still envisages the US outperforming its peers, and recently revised up its US growth forecast to 2.9% in 2018 and 2.7% in 2019. These represent big 0.6 and 0.8pp increases from the IMF forecasts made in October 2017.

In addition, US headline CPI in March was 2.4% YoY, versus 2.2% in February. Firmer price growth should assuage some policymakers' fears that higher inflation expectations may not be sustained. Hence, the Fed is still on course to hike rates at least twice more in 2018, with the next move expected in June.

Admittedly, USD/G10 pairs have tended to diverge from their respective interest rate spreads, particularly in 2018. The market has tended to focus less on actual US rate hikes, and more on the possibility that other central banks will choose to follow the Fed in reducing their accommodative policies, therefore supporting their currencies against the USD.

However, we expect little change in the ECB's position, and comments from the BoJ and SNB suggest that their ultra-loose policies will remain until well into 2019. Plus, the rate hikes which the market had been expecting from the BoE and BoC now look likely to be delayed.

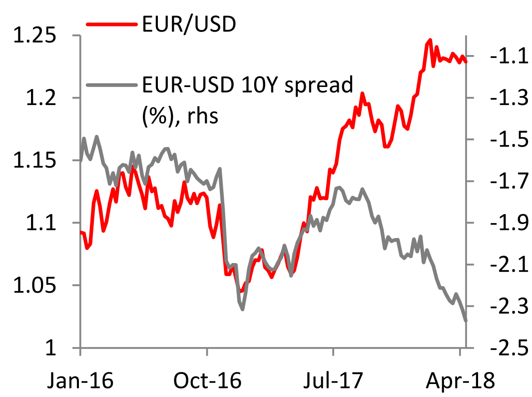
This dynamic should help emphasize the USD's undervaluation given current rate spreads. And, risk allowing, question the market wisdom of being so short a currency that is expected, in 2018, to outperform its peers both in terms of growth and rate hikes.

EUR – Defying gravity?

The EUR remains firm, and has held on to its 2017 gains, but remains unable to push higher. The Eurozone economic outlook remains robust, but recent data have tended to surprise to the downside. The ECB is expected to taper its asset purchases in H2-18, but not hike rates until late H1-19. Plus, low risk appetite, which had boosted the EUR versus the USD, seems to have stabilised.

The EUR's performance has been mixed over the last month. However, the effective EUR exchange rate has been stable for much of 2018. EUR/USD remains well above its level at the end of 2017, but has been in sideways range since early February, unable to break above that month's high of 1.2555, with support at its March low of 1.2155.

Chart 54: EUR/USD still diverging from spreads…



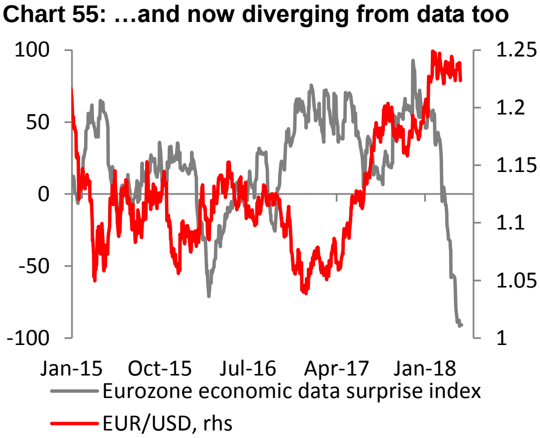
Source: Bloomberg, Santander

On the face of it, the economic outlook remains EUR positive. The ECB expects growth of 2.4% this year and 1.9% in 2019. The IMF is slightly more upbeat, and forecasts growth of 2% in 2019. However, this still implies that the Eurozone will underperform the US. This may be sufficient to keep EUR around its current levels, but is unlikely to be enough to propel it higher.

We still think that the market requires more 'good' news to feed the long EUR trade in the short term, and this has not been forthcoming. The preliminary March PMI figures were better than expected, but overall Eurozone data have surprised to the downside in 2018. However, the IMM non-commercial position data for the week ended 17 April showed that speculator's net long EUR/USD position reached an all-time high. But, these bets on further EUR/USD appreciation may owe more to USD negativity rather than the EUR.

The US administration's protectionist stance on trade has worried markets, reduced risk appetite and been viewed as a USD risk. But, recent rhetoric appears to have been more conciliatory. Further, geo-political concerns focusing on North Korea have also diminished. As such, equity markets have picked up in April, suggesting the risk backdrop is less EUR positive.

Chart 55: …and now diverging from data too



Source: Citi, Bloomberg, Santander

The ECB kept its policy unchanged in April. The Bank reiterated that it expects interest rates to stay at present levels well beyond the end of its asset purchase programme. It also confirmed that those asset purchases will continue until September 2018, or beyond, if needed.

We still expect the Bank to taper its asset purchases at the end of the year, but not hike rates until the end of H2-19. Interest rate spreads have, for a while, not been an efficient driver of EUR crosses. But, we continue to highlight that, with the Fed expected to hike at least twice more in 2018, the current and forecast EUR-USD spread is far more EUR/USD negative than the market is pricing in.

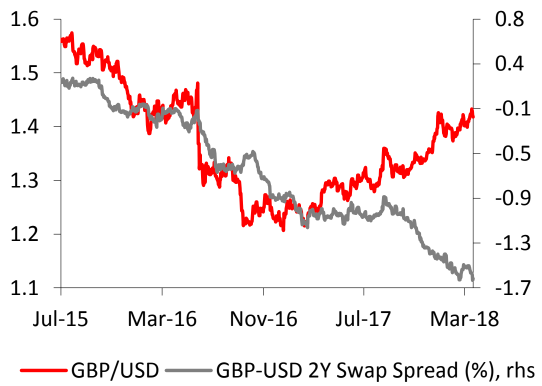
That said, EUR losses against the USD may be countered by gains versus other currencies. The correlation between EUR/GBP and EUR-UK spreads in 2018 has been stronger than for EUR/USD. If the BoE does leave rates unchanged on 10 May and the market starts to doubt whether lower UK inflation will leave scope for a UK hike at all in 2018, EUR/GBP could quickly move to test the 0.90 level again.

GBP – Caution in May

Sterling has outperformed since early March, despite its recent slip. But we still view the Pound as vulnerable over the forecast horizon. A more relaxed market approach to Brexit and UK politics has helped the currency, as had expectations of a BoE rate hike, although these have now diminished. However, recent downside data surprises suggest that nothing is certain and GBP bulls should be more cautious.

The Pound's performance has remained impressive. Since early March, Sterling has been one of the best-performing developed-market currencies. Momentum remained behind the buy GBP trade, helped by several factors.

Chart 56: Mind the gap – GBP/USD versus UK-US spreads

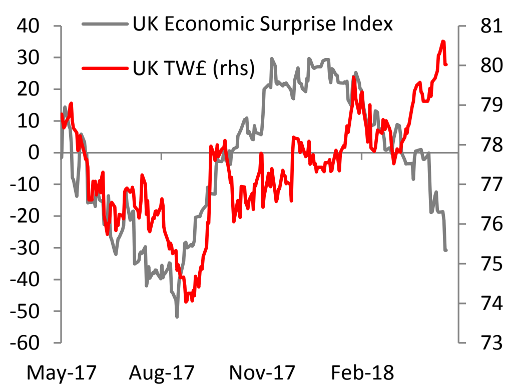


Source: Bloomberg, Santander

First, the market appeared less concerned about both Brexit and UK politics. A view that continues to be bolstered by the economy performing better than was feared immediately after the EU referendum in June 2016. Further, Sterling lovers had been encouraged by signals from the BoE of an imminent a rate hike. Plus, Sterling may also have been helped by a more stable EUR/USD, perhaps encouraging participants to question their directional strategies based on the USD and EUR.

But, we remain cautious on the scope for Sterling gains. The local elections on 3 May are expected to result in losses for PM May's Conservative Party. This, and the possibility that Parliament will pass an amendment to the EU withdrawal bill to force the PM toward a customs union with the EU, imply political uncertainty is still present. That said, the impact of such a scenario on Sterling could be ambiguous. The prospect of staying in a customs union, might be viewed as both economically and Sterling positive, and therefore outweigh any increase in perceived political risk.

Chart 57: Mind the gap – Sterling and economic data surprises



Source: Citi, Bloomberg, Santander

We have often stated that the Pound appeared oversold, given the UK economy has held up better than expected since the EU vote, but recent data have tended to surprise to the downside. The UK economic surprise index has been in decline, indicating that GBP outperformance hasn't been matched by economic data. Plus, whilst the IMF revised up its 2018 UK GDP forecast to 1.6%, the outlook remains lower than the US (2.9%) or the Eurozone (2.4%).

Interest rate expectations have also supported the Pound. The market had expected a 25bp hike in May. However, dovish comments by Carney on 19 April suggested that an imminent hike is now unlikely. He indicated that a rate hike remains "likely" this year, but conceded that data had been mixed, stating that he did not want to be too focused on the precise timing of any move.

The Pound slumped as the market priced out a hike, but even if rates are eventually increased, given the downside data surprises, in particular a lower March CPI, a future move looks likely to be a 'dovish' hike. And the BoE may be in no rush to tighten again anytime soon. We suspect this might be enough to pull the Pound back even further, especially against the USD.

Sterling may have been helped by a more stable EUR/USD over the past few months, which may have encouraged the market toward other G10 currencies for directional trades. But, given that the market is still very short USD, despite the US rate hike outlook, we still expect some reversal of USD weakness in the months ahead, which should imply more downside pressure on GBP/USD, even if Sterling can remain firm against the EUR.

Table 7: G10 FX forecasts

	Q2 18	Q3 18	Q4 18	Q1 19	Q2 19	Q3 19
EUR-USD	1.22	1.24	1.26	1.24	1.26	1.28
GBP-USD	1.36	1.34	1.32	1.32	1.33	1.35
EUR-GBP	1.11	1.08	1.05	1.06	1.06	1.05
USD-JPY	116	117	118	120	122	120
USD-CNY	6.6	6.65	6.7	6.8	6.7	6.7
EUR-CHF	1.17	1.18	1.20	1.22	1.23	1.24
EUR-SEK	10.00	9.90	9.60	9.50	9.50	9.30
EUR-NOK	9.50	9.40	9.30	9.10	9.00	8.80
USD-CAD	1.24	1.24	1.22	1.22	1.20	1.20
AUD-USD	0.8	0.8	0.8	0.8	0.8	0.8
NZD-USD	0.7	0.7	0.7	0.7	0.8	0.8

Euro interest rate forecasts

Government Bond yield Forecasts

Bunds	Current	2Q18	3Q18	4Q18	1Q19	2Q19	3Q19
ECB Refi	**0.00**	0.00	0.00	**0.00**	0.00	0.10	0.25
ECB Depo	**-0.40**	-0.40	-0.40	**-0.40**	-0.40	-0.40	-0.25
3m	**-0.65**	-0.70	-0.70	**-0.60**	-0.55	-0.35	-0.20
2y	**-0.57**	-0.45	-0.30	**-0.15**	-0.10	0.10	0.25
5y	**-0.04**	0.05	0.25	**0.35**	0.50	0.65	0.80
10y	**0.58**	0.65	0.80	**0.95**	1.15	1.30	1.40
30y	**1.24**	1.30	1.40	**1.50**	1.70	1.85	1.95

Swap rate forecasts

€ swaps	Current	2Q18	3Q18	4Q18	1Q19	2Q19	3Q19
ECB Refi	**0.00**	0.00	0.00	**0.00**	0.00	0.10	0.25
ECB Depo	**-0.40**	-0.40	-0.40	**-0.40**	-0.40	-0.40	-0.25
3m	**-0.33**	-0.33	-0.33	**-0.33**	-0.27	-0.14	0.08
2y	**-0.14**	-0.05	0.10	**0.20**	0.25	0.40	0.55
5y	**0.41**	0.50	0.65	**0.75**	0.85	1.00	1.15
10y	**1.01**	1.10	1.20	**1.35**	1.50	1.65	1.75
30y	**1.53**	1.60	1.65	**1.75**	1.95	2.10	2.20

US interest rate forecasts

Government Bond yield Forecasts

USTs	Current	2Q18	3Q18	4Q18	1Q19	2Q19	3Q19
FOMC (mid)	**1.625**	1.875	2.125	**2.125**	2.375	2.625	2.875
3m	**1.82**	1.90	2.00	**2.25**	2.50	2.75	3.00
2y	**2.49**	2.55	2.70	**2.85**	3.10	3.35	3.45
5y	**2.82**	2.85	3.00	**3.15**	3.40	3.60	3.70
10y	**2.97**	3.00	3.10	**3.25**	3.45	3.65	3.75
30y	**3.14**	3.15	3.25	**3.40**	3.60	3.75	3.85

Swap rate forecasts

$ swaps	Current	2Q18	3Q18	4Q18	1Q19	2Q19	3Q19
FOMC (mid)	**1.625**	1.875	2.125	**2.125**	2.375	2.625	2.875
3m	**2.36**	2.40	2.40	**2.55**	2.70	2.85	3.05
2y	**2.74**	2.70	2.75	**2.85**	3.10	3.35	3.50
5y	**2.92**	2.85	2.95	**3.10**	3.30	3.50	3.70
10y	**3.01**	2.95	3.00	**3.15**	3.35	3.55	3.65
30y	**3.03**	2.95	3.00	**3.15**	3.35	3.50	3.55

UK Interest rate forecasts

Government Bond yield Forecasts

Gilts	Current	2Q18	3Q18	4Q18	1Q19	2Q19	3Q19
MPC	**0.50**	0.50	0.50	**0.50**	0.50	0.50	0.50
3m	**0.51**	0.40	0.40	**0.45**	0.45	0.50	0.46
2y	**0.83**	0.65	0.40	**0.50**	0.55	0.60	0.70
5y	**1.17**	1.00	0.80	**1.00**	1.20	1.30	1.50
10y	**1.47**	1.60	1.40	**1.60**	1.70	1.80	2.00
30y	**1.87**	1.90	1.90	**2.10**	2.20	2.40	2.50

Swap rate forecasts

£ swaps	Current	2Q18	3Q18	4Q18	1Q19	2Q19	3Q19
MPC	**0.50**	0.50	0.50	**0.50**	0.50	0.50	0.50
3m	**0.71**	0.60	0.55	**0.55**	0.55	0.55	0.56
2y	**1.09**	0.95	0.80	**0.80**	0.95	1.00	1.20
5y	**1.39**	1.25	1.15	**1.30**	1.50	1.50	1.70
10y	**1.61**	1.70	1.50	**1.70**	1.80	1.80	2.00
30y	**1.68**	1.70	1.60	**1.70**	1.80	2.05	2.20

FX forecasts

	Current	2Q18	3Q18	4Q18	1Q19	2Q19	3Q19
EUR-USD	**1.206**	1.22	1.24	**1.26**	1.24	1.26	1.28
EUR-GBP	**0.877**	0.90	0.93	**0.95**	0.94	0.95	0.95
GBP-USD	**1.200**	1.36	1.34	**1.32**	1.32	1.33	1.35
USD-JPY	**109.5**	116.0	117	**118**	120	122	120
EUR-JPY	**132.1**	141.5	145	**149**	148.8	153.7	154

	Current	2Q18	3Q18	4Q18	1Q19	2Q19	3Q19
NZD-USD	**0.70**	0.7	0.7	**0.7**	0.7	0.8	0.8
USD-CAD	**1.289**	1.24	1.24	**1.22**	1.22	1.20	1.20
AUD-USD	**0.75**	0.8	0.8	**0.8**	0.8	0.8	0.8
EUR-CHF	**1.196**	1.17	1.18	**1.20**	1.22	1.23	1.24
EUR-SEK	**10.51**	10.0	9.9	**9.6**	9.5	9.5	9.3
EUR-NOK	**9.65**	9.5	9.4	**9.3**	9.1	9.0	8.8

IMPORTANT DISCLOSURES

ANALYST CERTIFICATION:

The views expressed in this report accurately reflect the personal views of the undersigned analyst(s). In addition, the undersigned analyst(s) has not and will not receive any compensation for providing a specific recommendation or view in this report: **Antonio Villarroya, Luca Jellinek, José María Fernández, Edgar da Silva, Laura Velasco, Antonio Espasa, Stuart Bennett, Adam Dent** and **Stuart Green.**

The analysts referenced in connection with the section for which he or she is responsible may have received or will receive compensation based upon, among other factors, the overall profitability of the Santander group, including profits derived from investment banking activities.

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EXPLANATION OF THE RECOMMENDATION SYSTEM

DIRECTIONAL RECOMMENDATIONS IN BONDS		DIRECTIONAL RECOMMENDATIONS IN SWAPS	
	Definition		**Definition**
Long / Buy	Buy the bond for an expected average return of at least 10bp in 3 months (decline in the yield rate), assuming a directional risk.	**Receive fixed rate**	Enter a swap receiving the fixed rate for an expected average return of at least 10bp in 3 months (decline in the swap rate), assuming a directional risk.
Short / Sell	Sell the bond for an expected average return of at least 10bp in 3 months (increase in the yield rate), assuming a directional risk.	**Pay fixed rate**	Enter a swap paying the fixed rate for an expected average return of at least 10bp in 3 months (increase in the swap rate), assuming a directional risk.

RELATIVE VALUE RECOMMENDATIONS	
	Definition
Long a spread / Play steepeners	Enter a long position in a given instrument vs a short position in another instrument (with a longer maturity for steepeners) for an expected average return of at least 5bp in 3 months (increase in the spread between both rates).
Short a spread / Play flatteners	Enter a long position in a given instrument vs a short position in another instrument (with a shorter maturity for flatteners) for an expected average return of at least 5bp in 3 months (decline in the spread between both rates).

FX RECOMMENDATIONS	
	Definition
Long / Buy	Appreciation of a given currency with an expected return of at least 5% in 3 months.
Short / Sell	Depreciation of a given currency with an expected return of at least 5% in 3 months.

NOTE: Given the recent volatility seen in the financial markets, the recommendation definitions are only indicative until further notice.
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