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Interest & Exchange

FX Dynamics & Implications for Financial Markets

Global Strategy: With investors watching US short- and long-end rates very closely, given their potential implications for global financial markets, for the time being we maintain our Fed and UST forecasts unchanged. But we believe the market is underestimating the importance of several US rates drivers, namely government bond supply and FX. We remain EUR bulls in the medium run (EUR/USD to end the year c.$1.26) but the recent decline towards the $1.21-1.22 area was within our expected range.

US Macro: The release of January CPI numbers raised concerns among investors about a sharper and faster increase in inflation, and consequently, about more aggressive Fed monetary policy tightening. According to our estimates, annual CPI growth rates would move towards the 2.5% area in 2Q18E, but we do not expect much higher rates in the short term. Moreover, we still believe that hourly wages are under control in the short run, moving upwards progressively.

US Rates: We continue to think that the bearish momentum in short-dated US rates is fully justified (pay 2y2y) and that changing supply dynamics will continue to weigh on USTs, especially vs. swaps (sell 30y UST in ASW). However, in the belly and long end, some kind of consolidation or even a slight correction is starting to look increasingly probable (receive 15y vs. 5y5y), especially vs. the front- and ultra-long ends of the curve (receive the belly in 5s10s30s).

EUR Macro: Euro zone inflation rose to 1.5% YoY in 2017, mainly thanks to the energy component's contribution. We anticipate a more evident upturn in core inflation in 2018E, in a context of upside domestic risks.

EUR Rates: Solid growth has yet to translate into higher inflation, limiting changes in ECB policy and the sell-off has run out of steam somewhat. Gradual rebuilding of term premia and the pull of US rates as the main sources of higher euro rates so we favour curve steepeners and US-EA wideners. The major event risk for periphery are the Italian elections.

GBP Macro: Publication of the EU's draft Withdrawal Agreement for the UK, outlining the EU's preferred 'fall-back' scenario for the Irish border issue, has served to highlight the obstacles to a smooth Brexit process. We believe the fundamentals of the UK economy already question the need for a higher level of Bank Rate, and argue that this additional uncertainty surrounding the Brexit transition presents a further key argument for caution on UK monetary policy.

GBP Rates: Outright rates in the UK have been flattening across the board, putting the very shortest dates (sub-2y) under most pressure. We consider BoE hike pricing to be excessively front-loaded, and the front end of the curve as likely to steepen. Long-end flattening, on the other hand, could go even further, towards the inverted profile which was typical in the pre-crisis era. The 12y gilts have underperformed the overall bull-flattening trend, and we expect them to catch-up.

G-10 FX: The USD has picked up recently, we still think that the market has adopted too negative a stance on it. We suspect that the USD selling frenzy should run out of steam, ahead of the expected Fed rate hike. We still believe the EUR is slightly on the expensive side. The EMU economy is robust, but its impact on FX sentiment should now have been priced in. Sterling has posted a notable recovery against its developed-market peers over the last few months. We are sceptical about whether this will continue, and still see the Pound as vulnerable.

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

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Santander GLOBAL CORPORATE BANKING

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

	USD	EUR	GBP
Economic Outlook	We estimate GDP growth of 2.2% in 2017E, 2.5% in 2018E and 2.6% in 2019E, helped by private consumption and investment, after the inventory adjustment.	We now estimate GDP at 2.3% in 2017E, with strong domestic demand and improving exports leading to +2.2% in 2018E and +2.1% in 2019E, with the four major countries contributing positively.	We expect GDP growth to remain at a c. 1.5% pace in 2018, with investment constrained by ongoing Brexit uncertainty. Falling inflation should boost 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, but anticipate more hawkish commentary from the MPC in 1H18.
Rates / Duration	The monetary policy normalization , healthy macro environment and potential changes in supply/demand equilibrium should weigh on USTs all along the curve.	The macro and policy outlook point to higher rates over the course of 2018. There is room for more correction, near-term, especially if USD rates also take a pause.	An over-reaction to MPC hawkishness has pushed short rates too high, especially for the coming year, but longer-term rates are likely to grind higher.
Curve / Slope	We remain bearish the front end (pay 2y2y) but see a risk of some correction in the belly, at least relative to wings (receive the belly in 5s10s30s and 15y vs. 5y5y).	Policy rate expectations built into the short end are more fairly priced than the term premia. We recommend steepening trades like 30y-10y.	The long end has stayed very firm despite front-end swings, and we would not rule out 10s30s hitting zero. 2s5s and 5s10s should re-steepen if short rates stay elevated.
Spreads	Gradually unwinding SOMA reinvestments pose a risk for USTs. We like swap spread wideners (bearish USTs), especially in the ultra-long end.	The effects of Italian political risk and heavy supply in January-February are likely to gradually fade. Conversely, economic recovery and potential ratings upgrades should support periphery EGBs.	Supply and liquidity conditions make for a gilt-supportive environment, but this looks fully priced in to long gilt spreads. 3-5y spreads look too wide/flat.
Volatility	With the exception of the top-left corner, implied vols have corrected down, making the bottom-right corner attractive again.	Implied vols increased in line with realised vol and reminders that substantial short-vol positions are likely to be reduced. Medium-term, central banks will tend to cap the increase in realised vol.	Top-left implied vols have finally staged a decent rebound, but longer tenors/expiries have stalled below 3Q17 levels, even after recent delivered vol.
Inflation / Break-evens	With the market focus switching to concerns about accelerating inflation, BEs should remain particularly sensitive to upward data surprises and should increase further.	10y ILS levels (1.6%) are now above accruing actual inflation (1.2% ex-tobacco) and are likely to rise at a more moderate pace, in future.	UK CPI has likely peaked, but should hold at around 2.8% in coming months, before decelerating in H2-18. Wage growth is now key, but UK labour data is noisy.
FX	The USD remains relatively weak. The mix of a strong economy and further Fed rate hikes in 2018 should provide support, but short-term momentum could imply further weakness.	EUR/USD gains still look a bit excessive, though economic data have been strong and supportive. The ECB's status quo stance and wider US-EU yields should weigh eventually, but for now are being ignored.	Sterling has been firm, but much of the GBP/USD rally is due to dollar weakness. The Pound remains vulnerable to slower GDP, CPI and political/Brexit uncertainty.

Source: Santander Economics, Rates and FX Strategy Research. For a full list of contributors, please see contact details on page 37.

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) Buy SPGB 2.9% Oct-46; sell Bund 2.5% Aug-46** at 120bp. Target = 115bp. **2) BTP-SPGB 2030-2033 box trade** at 8 ½ bp. Target 0 bp.	**Gilt 30s/46s ASW box steepener** Entry level = 20.8bp. Target level = 25bp. Stop loss = 17bp.
Rates	**1) Receive the belly in 5s10s30s** Entry level = 5bp.Target = 0bp. Stop loss = 7.5bp **2) Receive 15y vs. pay 5y5y** Spread entry level = 7bp.Target = 30bp. Stop loss = -5bp **3) Pay 2y2y in USD swaps** Entry level = 2.90%.Target = 3.10%. Stop loss = 2.85%	**1) Receive 10y IRS / pay 30y IRS** Now 48bp. Target=70bp **2) Pay USD 5y / Receiver EUR 5y** Now 214bp. Target=250bp	**1) GBP 1s5s OIS steepener.** Entry level = 40bp. Target level = 50bp. Stop loss = 36bp. **2) Buy 20y gilt inflation break-even (outright or vs. 10y).** Entry level = 343bp. Target level = 350bp. Stop loss = 335bp.
FX	**Buy USD/JPY** at 107.00 target= 114, with a stop loss at 104.00	**Sell EUR/NOK** original entry at 9.80, but now 9.60, target= 9.30, with a stop loss at 10.05.	**Sell GBP/NZD** original entry at 1.9150, now target= 1.7500, with a stop loss at 2.0000

Global Strategy: FX dynamics & implications for financial markets

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With investors watching US short- and long-end rates very closely, given their potential implications for global financial markets, for the time being we maintain our Fed and UST forecasts unchanged. But we believe the market is underestimating the importance of several US rates drivers, namely government bond supply and FX. We remain EUR bulls in the medium run (EUR/USD to end the year c.$1.26) but the recent decline towards the $1.21-1.22 area was within our expected range.

The macro outlook has barely changed in the last few weeks. At the margin, despite a small decline in several Euro Area business surveys (Chart 1), confidence in the depth and breadth of the ongoing economic recovery remains solid, which has also helped risky assets recover quickly after the early-February scare. This sanguine outlook, together with comments (or lack thereof) from some central bankers in the US, UK and Euro area, reinforces the idea that 2018 will be the year when these regions will start to notice a substantial pull back from their extremely accommodative monetary policies. Yet, in addition to the macro fundamentals behind this shift in (conventional and non-conventional) monetary policy expectations, it is also important to assess other explanatory factors and the market implications.

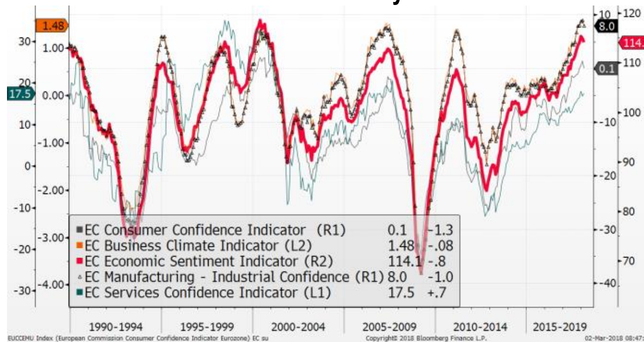
In the US, neither the recent macroeconomic data nor the surveys have been far off market expectations. But **the main threat we see at this stage is the probability of some acceleration in both core inflation and negotiated salaries**, given the tight labour market and even some anecdotal evidence of how some US firms are planning to spend part of the recent tax reform windfall. It could even be argued that the January hourly earnings figure (+2.9% yoy, from 2.4% one year earlier) was one of the drivers behind the quick correction in rates, as well as in equities over the following days. Looking at the US core inflation number released two weeks later, despite remaining in a tight 1.7-1.8% range(*) for the ninth month running, the underlying factors seemed solid enough to foresee the 2% annual core inflation level will be broken through in the coming months, helped by a very poor base effect (+0.3% cumulative growth between March and July 2017).

(*) The rounded annual growth figure for US Core inflation in Feb'18 was 1.8455%

Ignore FX at your peril

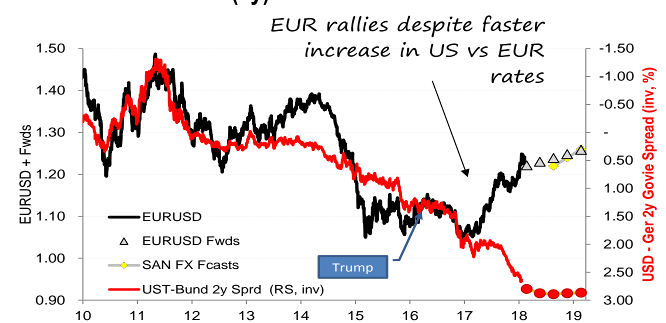
Inflation and wages were two of the drivers we mentioned that we thought could contribute to higher US rates. But another important macro driver has not received the attention it deserves, in our view: the exchange rate. Spurred by some senior US officials' comments, the recent USD weakness is likely to add some extra pressure for US (imported) inflation, while helping this country's competitiveness. In fact, despite the recent correction, the trade-weighted USD is -12% yoy.

Chart 1: Euro Area Confidence Surveys



Source: EC, Santander

Chart 2: EURUSD vs (2y) USD-EUR rate differentials



Source: Bloomberg, Santander

In this regard, as our FX team has been highlighting for quite some time, although we expected some retracement after the last leg of the EUR rally, as it seemed overbought to us, in the medium-/ long-term we remain EUR bulls. And we believe this could have major implications for both the US and Eurozone monetary authorities, with sizeable potential consequences for

global financial markets. Indeed, we continue to believe a monetary policy error remains the #1 potential catalyst for a sharp market correction.

Having been EUR bulls for quite some time, we saw a potential decline towards the $1.21-1.22 area during 1H18 as likely, as EUR was probably overbought. We think EUR/USD will resume its upward trend in 2S18 to end the year above $1.26.

Although there are always multiple drivers –and with varying weights– behind FX movements, with many analysts now focused on the large-and-growing US twin deficits, we believe the recent EUR/USD move has more to do with macro fundamentals, with the EUR having found solid support from clearly better-than-expected European economic prospects.

As it seems obvious that Interest Rate Differentials (IRD) have lost a lot of their explanatory power to drive currencies (Chart 2), given how intervened rates markets still are (especially in the front end, and in the Euro area), at this stage we think we need to focus more on growth dynamics to assess some G10 currencies performance. Chart 3 below shows the performance of the EUR/USD exchange rate compared to consensus GDP growth expectations for the Euro area vs. the US, for 2017 and 2018.

The chart shows how in mid-2016 the consensus expected the US economy to grow 1% faster than the Euro area, but the reality is that the EZ will probably have outpaced the US by c.0.2% (2.5% vs 2.3%). For 2018, the market currently expects the US to grow 0.5% faster than the EZ (2.7% vs 2.2%). We currently forecast the Euro Area to grow 2.3% (although with a clear upward bias), and we are less optimistic on the US (at 2.5%).

We therefore believe this factor should now be mostly priced in for the near future, but **still believe it could help the EUR in the medium run**. In the meantime, although it is a shorter-term driver, we will keep an eye on these areas' 2-5y box spread (i.e., EUR vs. USD 2-5y slope, Chart 4), as it combines the IRD argument with mid-term growth expectations in a maturity (> 2y) that should not be that affected by the ECB's ongoing QE experiment.

Having been EUR bulls for quite some time, we saw a potential decline towards the $1.21-1.22 area during 1H18 as likely, as EUR was probably overbought. We think EUR/USD will resume its upward trend in 2S18 to end the year above $1.26

Chart 3: EUR/USD exchange rate vs US - EUR expected growth differential (for 2017 and 2018) as per BBG consensus

Source: Bloomberg, Santander

Chart 4: EUR/USD exchange rates vs EUR-USD 2-5y box spread (EUR slope – USD slope)

Source: Bloomberg, Santander

We believe the combination and interaction of these three drivers (core inflation, wage growth and FX movements) have the potential to lead the market to be concerned about the Fed's possible reaction to upward moves in inflation expectations that, at least for the time being, remain relatively contained.

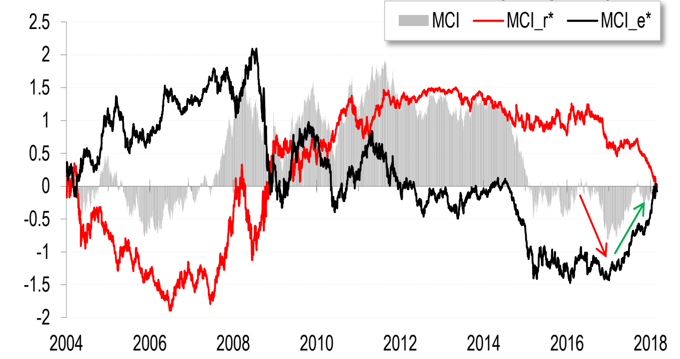
As seen in Chart 5, supply dynamics (our other main fear regarding US rates, given the funding of the tax package in an already large fiscal deficit / high public debt environment) seem to have taken US nominal rates clearly above break-even inflation expectations for the first time since the financial crisis.

The USD decline is also key for US monetary policy, as it offsets the impact of rising short-term rates on future US inflation. As seen in Chart 6, both components of our US Monetary Conditions Index (MCI) have basically offset each other. In other words, the expected 'cooling' impact on future inflation of the recent tightening via short-term rates (USD 1y1y IRS has risen from 1.5% in Sep'17 to the current 2.64%) has been counterbalanced by the above-mentioned 12% decline in the USD NEER over a similar period (Chart 6).

Chart 5: US 5y5y BE vs 10y UST yield

Source: Bloomberg, Santander

Chart 6: Monetary conditions in the US: Exchange rate vs US short-term rates' impact on future US inflation (five years)



Source: Bloomberg, Santander

Table 1: Main US long-end rates Drivers

Short-term Rates	
FED:	
Market still underprices the 'dot chart' hikes	Δ
New FOMC - shouldnt alter the Fed's stance	=
Inflation:	
Core CPI cld move to 2.0-2.3% area	=/Δ
Wages growth could accelerate slightly	Δ
DXY (& Oil) px moves to add inflationary pressure	ΔΔ
Real rates:	
GDP might already be close to the highs of this cycle	=

Long-term Rates	
SUPPLY	
Fiscal Deficit ($563bn in 2018, $2.9trn in 2018-2021)	ΔΔ
Tax Reform (+$136bn in 2018, $0.9trn in 2018-21)	Δ
Fed's b/s reduction (+$252bn in 2018, $1trn in 2018-21)	Δ
DEMAND	
Domestic Banks (+$740bn since 2014, could stabilize now)	=
International CBs/China =f(FX reserves)	=/∇
EUR/JPY investors (supportive given IR differentials)	∇
Fast Money accounts (close to all-time shorts)	∇
Other assets (Risky assets at all time highs, rotation?)	=/∇

* ΔΔ / Δ / = / ∇ / ∇∇ refers to the impact on US rates / UST yields

Source: Santander

For more info see our 2-Feb-2018 Interest & Exchange 'Right Direction, Wrong Speed'

Fed & UST View - Uncomfortably Unaltered Position

As mentioned last month, despite all these factors, and acknowledging a clear upward bias, we maintain our Fed and UST calls unchanged. Regarding the Fed, the market has not only caught up with our call of three hikes this year, but is even already assigning chances of a fourth. We believe US monetary conditions are still accommodative, especially once we take the Fed's balance sheet increase into account, and that this economy could handle a fourth hike this year perfectly well. But, bearing also in mind that basically just one hike is priced in for 2019, we think the Fed might be wise to take a pause in its quarterly hiking pace given the clearly asymmetrical risk for financial markets.

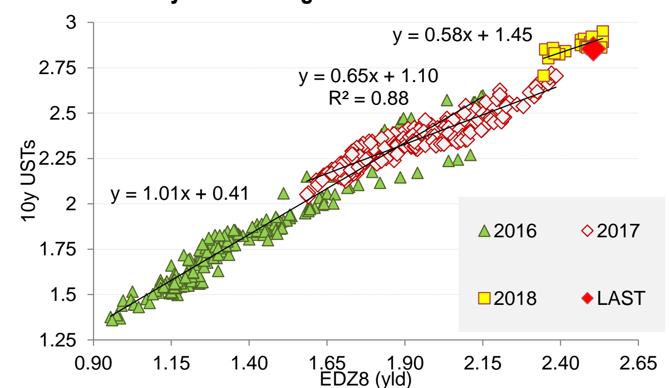
Looking at the long end of the curve –and obviously biased by the above Fed call– we still maintain our long-held 3.25% forecast for 10y Treasuries at the end of this year, as we think US rates are starting to offer value at current levels compared to other similarly overpriced assets, while a stable yield period could force fast money accounts to close some of their huge shorts in US rates (Table 2). That said, given the 60% beta between US long-end rates and official rate expectations (Chart 7), if we opted to add a fourth Fed Funds hike to our call for this year, we would need to –at the least– automatically add another 15bp to our 10y UST forecast. Here, we reiterate our concern about fast-growing supply as, in a UST price deflation scenario, investors could opt to delay entering this market, as there will be sufficient supply to cope with the eventual yield-grabbing demand.

Table 2: CFTC fast money positions in US rates (via futures) by maturity (all in 10y equivalent, USD bn)

20-Feb-18	$bn 10y Equiv	1w chg	4w chg	$bn 10y Equiv 10yr Z-Sc	10y Hi	10y Lo
30d	(2.1)	3.6	(0.4)	(0.2)	18	(17)
3m	(141.2)	(7.6)	(23.5)	(3.1)	62	(141)
2y	(9.6)	(0.3)	7.9	(1.8)	14	(19)
5y	(32.4)	(4.8)	3.0	(2.4)	23	(39)
10y	(48.6)	5.9	(8.9)	(2.5)	20	(65)
20y	(7.3)	2.3	(12.7)	(0.3)	21	(28)
Total	(241.2)	(0.9)	(34.6)	(3.3)	71	(243)

Source: CFTB, Santander

Chart 7: US 10-year rates regressed vs short-term rates



Source: Bloomberg, Santander

Table 3: US, German, Italian and Spanish Government bond yields and 3mth changes

Now	UST	Germ	Spain	Italy
2y	2.23	-0.57	-0.24	-0.21
5y	2.60	-0.00	0.35	0.68
10y	2.83	0.62	1.48	1.92
30y	3.10	1.28	2.50	3.01
CHG	UST	Germ	Spain	Italy
2y	47	12	12	14
5y	49	30	-1	16
10y	44	24	0	13
30y	28	6	-25	5

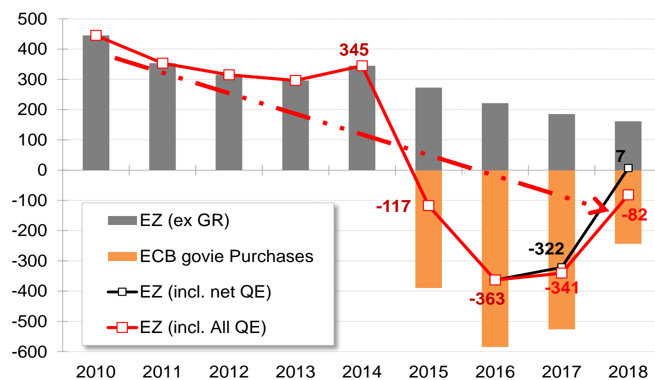
Source: Bloomberg, Santander

Follow the leader … at a distance

As expected, with the ECB still buying basically all this year's net supply of EUR-denominated sovereign paper (Chart 8), Euro bonds are replicating, with a below-one beta, the movements in US rates. In fact, the extent of German Bunds' increase in January –compared to USTs– seemed too large to us, but it has recently corrected. Accordingly, so far this year, 10y German bonds have replicated 50-60% of the 45-50bp sell-off in Treasuries -now much closer to our expectations-, with this German-US beta being higher in the 5-10y areas vs the wings. Going forward, as we are maintaining our call for 10y USTs at 3.25% for now, this elasticity would take 10y Bunds towards the 85-90bp area, although the correlation and beta will also depend on the ECB's decision regarding the timing of the end of its EAPP (Sep vs. Dec).

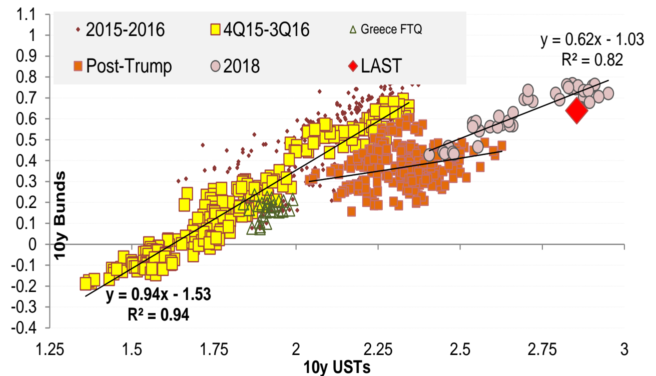
We find the very low (or even negative) beta of periphery countries particularly interesting, with Italy only replicating a very small fraction of the movement in core rates and with Spain's long end basically flat in the year (despite hefty DV01 issuance in both countries, see page 20).

Chart 8: Euro Govies Net Supply vs ECB Govie Purchases



Source: Bloomberg, Santander

Chart 9: German 10y Govt Yield Regressed over 10y UST



Source: Bloomberg, Santander

A related aspect, especially for the EUR front end and the ECB's exit strategy calendar is that, to a large extent, all the above comments about USD weakness could be 'mirrored' as EUR strength, which remains fairly strong (especially trade-weighted) despite the recent correction. The additional aspect is that this strength is making the ECB not fulfil its sole inflation mandate despite the above-mentioned sanguine growth outlook.

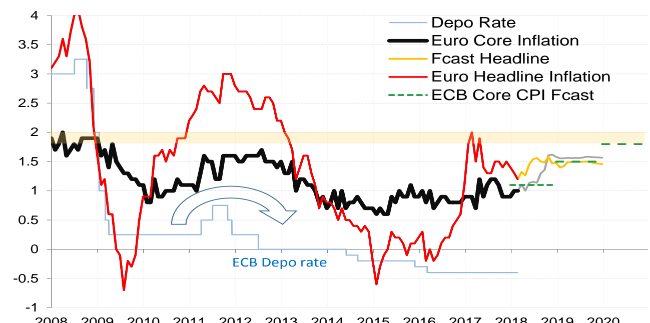
And although confidence in achieving this target continues to grow (slowly), according to the ECB's own forecasts Draghi could step down late in 2019 without achieving this target. And a stronger EUR could even delay this further. Accordingly, we believe that, besides core inflation, real growth or wage settlements, a strong EUR (say, above $1.28) could tilt the balance among the ECB's GC towards continuing to buy bonds, even if at a very low pace, in 4Q18. This should make the market push its first ECB rate hike expectations out to mid-2019, compared to the current market pricing of a 70% chance of a10bp increase in the depo rate before the year-end. We would advise investors to keep a very close eye on FX market developments.

Table 4: EUR trade weighted movements by currency pairs

Country	Weight	Last	02-Mar-17	Change 1y	Impact
China	22.3%	7.82	7.24	7.9%	1.8%
US	16.0%	1.232	1.05	17.2%	2.8%
UK	13.1%	0.89	0.86	4.2%	0.5%
Switz.	7.0%	1.15	1.06	8.1%	0.6%
Japan	6.7%	129.7	120.3	7.8%	0.5%
Poland	6.4%	4.19	4.29	-2.3%	-0.1%
Czech R.	5.2%	25.4	27.0	-6.0%	-0.3%
Sweden	4.5%	10.16	9.54	6.5%	0.3%
S. Korea	4.0%	1326	1202	10.3%	0.4%
Hungary	2.9%	314	309	1.4%	0.0%
Denmark	2.2%	7.45	7.43	0.2%	0.0%
Romania	2.1%	4.66	4.52	3.0%	0.1%
					7.4%

Source: Bloomberg, Santander

Chart 10: EUR inflation and forecast



Source: Bloomberg, Santander

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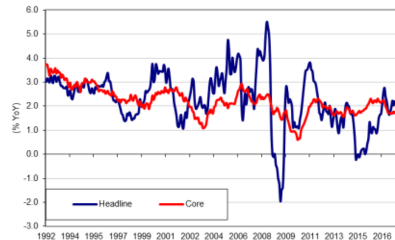
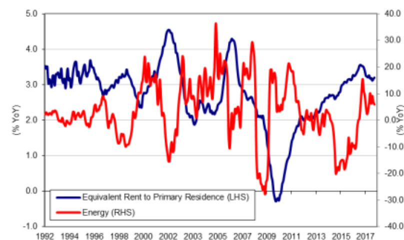
The release of January CPI numbers raised concerns among investors about a sharper and faster increase in inflation, and consequently, about more aggressive Fed monetary policy tightening. According to our estimates, annual CPI growth rates would move towards the 2.5% area in 2Q18E, but we do not expect much higher rates in the short term. Moreover, we still believe that hourly wages are under control in the short run, moving upwards progressively. We maintain our CPI forecasts of 2.3% in 2018E and 2.5% in 2019E.

Chart 11: US – CPI headline vs core, 1992-Jan18



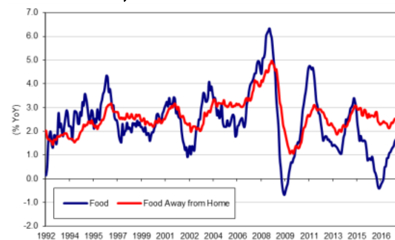
Source: BLS and Santander.

Chart 12: US – CPI housing vs energy, 1992-Jan18



Source: BLS and Santander.

Chart 13: US – CPI food vs food away from home, 1992-Jan18



Source: BLS and Santander.

January CPI numbers raised concerns about more aggressive Fed tightening

January's inflation numbers surprised the market on the upside, raising fears about an unexpected and sharper increase in prices in coming months. Moreover, if prices move upwards more than previously expected, the Federal Reserve's monetary policy could also move faster and more aggressively than previously expected. The recently published average hourly earnings growth rates also contributed to increase market anxiety about future Fed decisions.

In our view, although prices are progressively moving upwards and we believe they will keep doing so in coming months, we do not see them skyrocketing in 2018E and, consequently, triggering a more aggressive tightening of monetary policy by the Federal Reserve. Our forecasts point to CPI increasing 2.3% in 2018E and 2.5% in 2019E, after having risen by 2.1% in 2017.

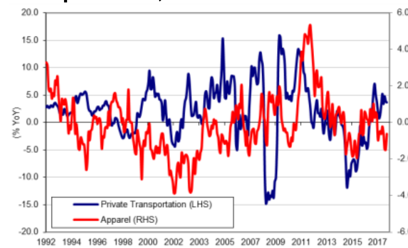
Acceleration of annual CPI growth is likely to continue, although at a moderate pace. We expect annual rates of c. 2.5% from 2Q18E onwards

CPI growth accelerated its rates in January, at 0.5% MoM from 0.2% MoM in the previous month, marking the fastest pace since August 2012 (0.6% MoM). The January annual growth rate (2.1%) maintained the same level as in the previous month and the average of the last 12 months, so there were no surprises from that side, in our view. The core index also rose more than expected in January (0.3% MoM), leaving the annual growth rate at 1.8%, again the same rate as in the previous month and the average seen in the last 12. So, there were no significant changes in the January numbers, apart from the fact that they came in higher than expected. Having said that, we expect headline CPI growth rates to accelerate in coming months, moving to an annual rates of c.2.5% in 2Q18. For core CPI, we expect growth rates to be at c.2.1% in 2Q18E and onwards.

Looking at the CPI breakdown, we find some interesting trends in some of its components. The January monthly increase in the headline CPI is due largely (c.0.2pp of the monthly growth rate) to the 3.0% MoM increase in energy prices. Actually, due to base effects, the energy component could contribute positively to the monthly headline CPI growth rate in 1H18. Food prices are progressively leaving behind the negative, or very low, growth rate territory seen during2Q16-2Q17, and are now growing by 1.7% YoY, with the monthly pace at 0.2% in January 2018 (0.1% average in the last 12m). Food at home has moved out of deflationary territory, but is still showing modest monthly growth rates, while the main inflation generator is the food away from home component (0.4% MoM, 2.5% YoY in January from 2.3% average in last 12m).

At the core level, commodities less food and energy posted an increase of 0.4% MoM (-0.7% YoY), mainly driven by apparel (1.7% MoM, -0.7% YoY) and used cars and trucks (0.4% MoM, -0.6% YoY). In our view, the trends in the main components of commodities less food and energy still show low risks of much higher prices in the short run. Note that apparel remains in deflationary territory (negative annual growth rates since May last year), as do new and used motor vehicles (-0.4% YoY in January and an average of 1.1% since April 2016). Conversely, medical care commodities show an annual increase of 1.8%. In our view, although some of those indices could show slightly stronger annual growth rates in the coming months, we do not expect them to skyrocket in the short run.

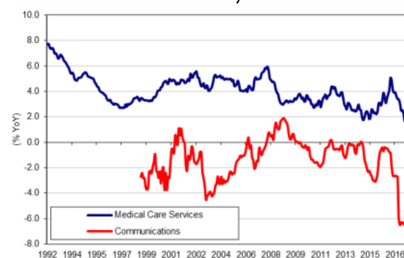
Chart 14: US – CPI apparel vs private transportation, 1992-Jan18



Source: BLS and Santander.

Services less energy services –the core CPI component with the highest weighting (59.2% of total)– actually maintained the same growth rates as in previous months. January saw an increase of 0.3% MoM with the annual growth rate at 2.6%, which is in line with the average seen in the last 12 months and below the levels of more than 3.0% YoY seen in the Jan16-Feb17 period. Shelter –the single CPI component with the highest weighting (32.8% of total) –actually decelerated to an annual pace of 3.2% in January from the 3.5% average in the May16-May17 period, and seems likely to remain stable at slightly above 3.0% YoY. Medical services, which grew by as much as 5.1% YoY in August 2016, is now showing growth rates of c. 2.0% YoY, with hospital and related services being the component that pushed the monthly rate up to 0.6% MoM in January. Hospital and related services posted an increase of 1.2% MoM in January, which is unlikely to be repeated in the coming months, which would probably help to decelerate the annual growth rate from the current 5.6%.

Chart 15: US – CPI communications vs medical care services, 1992-Jan18



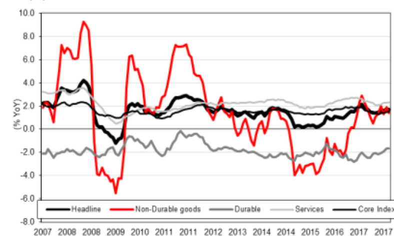
Source: BLS and Santander.

On the other hand, some deflationary components (communications mainly) might show some moderation in their recent negative growth rates (that is, they could moderate their pace of decline from the current levels). Communication fell by 4.9% YoY in January versus an average decline of 5.5% in the last 12 months.

In summary, we expect inflation to move progressively higher towards the 2.5% area, but do not think prices are likely to jump sharply higher in coming months, triggering an unexpected reaction from the Fed.

PCE deflators also tell the same story…

Chart 16: US – PCE deflators, 2007-Dec17

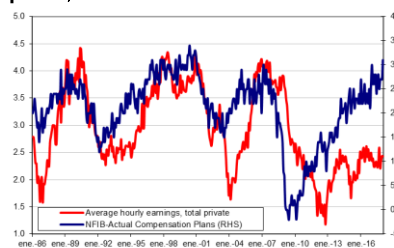


Source: Datastream and Santander.

The PCE deflators point in the same direction, having risen 1.7% YoY in December, in line with the 1.7% posted for 2017 as a whole. Interestingly, non-durable goods are more or less stable at c.1.4% YoY, while durable goods are in negative territory, although with the annual rate (-1.7% YoY in December) showing a less negative rate than in the last two years. The services sector deflator –with the highest weighting– remains quite stable in its annual terms (2.3% in December versus 2.3% for 2017 and 2.5% in 2016). Although the services PCE deflator could move towards 2.5% in 2Q18E, we do not expect it to reach higher levels on a sustainable basis this year. Finally, in the case of the core PCE deflator, we expect annual growth rates to pick up from 1.5% last December to slightly below 2.0% in 2Q18E. However, we do not expect growth above the 2.0% level, on a sustained basis, in the coming months.

Salaries still under control, as per recent hourly wages data

Chart 17: US – Average hourly earnings vs NFIB-actual compensation plans, 1986-Jan18



Source: Datastream and Santander.

The January labour report showed that there are still no across-the-board inflation pressures from the wages side, a situation we expect to persist in coming months. Average hourly wages grew by 0.1% MoM/2.4% YoY in January, remaining basically at the same levels as in the last 12 months. The tightening of the labour market between supply and demand is, in our view, the main driver of a future acceleration in wages growth rates. However, we do not see this strong tightening happening soon, ultimately give the Fed more time to hike rates progressively. In any case, we will analyse wages in more detail in future publications.

US Rates Strategy: Value in receiving the belly vs. the wings

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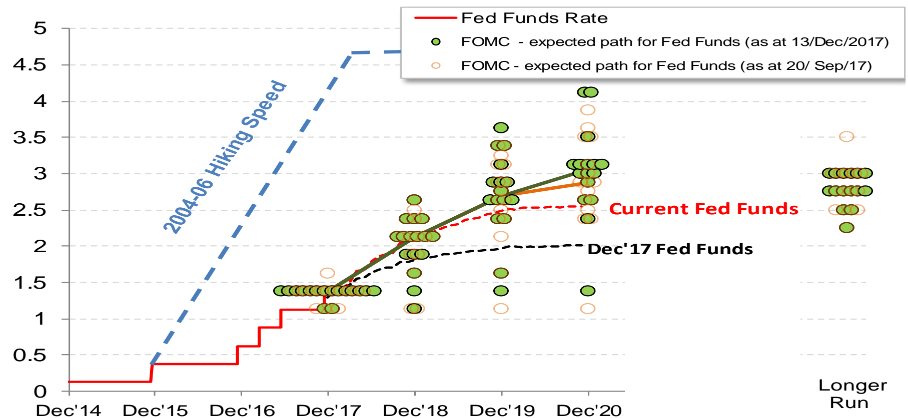
- **We continue to think that the bearish momentum in short-dated US rates is fully justified (and even likely to continue, although at a much more moderate pace).**
- **Further out the curve, the movement in the belly and long end seems to have lost steam when the 10y has approached the 3% mark. While fundamentals and underlying risks still favour higher rates in these tenors, medium term, some kind of consolidation, or even a slight correction, is starting to look increasingly probable , especially vs. the front- and the ultra-long ends of the curve.**
- **We continue to like the tactical positioning suggested in the previous edition of this report (receiving the belly in 5s10s30s), which is already in the money and could offer some additional gains. For new players, we recommend shifting the trade into the 15y area (receive the 15y and pay the 5y5y).**
- **On a longer-term basis, we feel comfortable with the strategical positioning suggested in our Year-Ahead report: shorts in the front end (paying the 2y2y) and bearish on USTs vs swaps, especially in the ultra-long end (selling the 30y UST in ASW).**

Front-end rates: Market catching up with the dot chart

After the sizeable repricing seen in the last couple of months, front-end rates are significantly closer to fully pricing in all the rate hikes suggested by the Fed's latest dot chart. As shown in Chart 18, not only have market expectations for 2018 already fully converged with the median of the FOMC dots (2.10% vs. 2.125%), but they have also almost priced in those for 2019 (2.50% vs 2.688%). However, we still see room for additional increases in 2020, where the median of the dots remains 50bp higher than current FF futures, and we believe the risk remains biased towards the market extending the bearish momentum.

Chart 18: December 2017 FOMC dot chart vs. FF futures



Source: Federal Reserve, Santander.

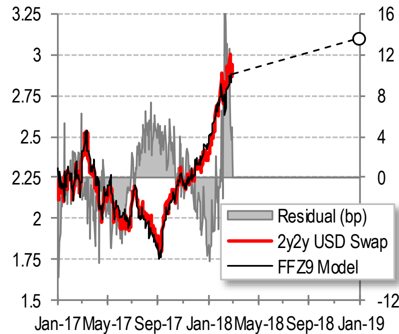
Table 5: 2y2y USD swap – historical performance explained by FFZ9 future

	1.25-1.50%	1.50-1.75%	1.75-2.00%	2.00-2.25%	2.25-2.50%
21-Mar-18	0%	93%	7%	0%	0%
02-May-18	0%	48%	52%	0%	0%
13-Jun-18	0%	38%	62%	0%	0%
01-Aug-18	0%	0%	87%	13%	0%
26-Sep-18	0%	0%	40%	60%	0%
08-Nov-18	0%	0%	24%	76%	0%
19-Dec-18	0%	0%	0%	58%	42%

Source: Bloomberg, Santander.

Since the release of surprisingly stronger-than-expected average hourly earnings for January, back on 2 February, the market has opened up to the possibility of the Fed accelerating the pace of hikes for 2018 and delivering not only the three 25bp hikes depicted in the dot chart, but even a fourth hike before the end of the year (Table 5). For the time being, we do not think that inflation concerns are strong enough to push the new Fed Chair into embarking on quarterly hikes (so we continue to expect another pause, probably in June or September). But, we also think that, while unlikely, the probability the market is assigning to that fourth hike could actually increase in the event of another bullish inflation print.

Chart 19: 2y2y USD swap – historical performance explained by FFZ9 future



Source: Bloomberg, Santander.

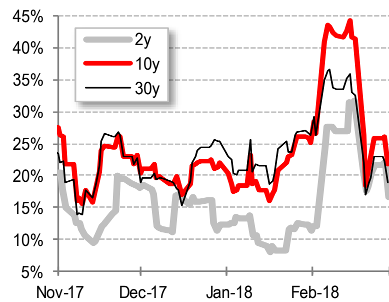
Therefore, now that the 2y2y is approaching our target again (2.90% as we write, vs. our 3.00% target set on 2 February), we feel comfortable about maintaining our strategical short in the front end of the US curve and are revising the target up to 3.10% (the level we consider consistent with FFZ9 at the 2.6875% dot's median, see Chart 19).

- **Trade idea: Pay 2y2y**
  Entry level = 2.90%. Target level = 3.10%.
  Stop loss = 2.85%. 3m roll-down = -1.5bp

We opened this trade on 29 September, when the spread was at 2.10%, with a target at 2.40%. We then revised the target in our Year-ahead report (to the 2.70% area) and did so again last month (to 3%). Potential gains are definitely much more limited now (we target 3.10%). For newcomers, we would recommend a tight stop loss at 2.85%, but for those already in the trade, we believe that the movement could continue and, while slower than in previous months, we still expect it to beat the negative roll-down (-1.5bp during the first three months).

Belly much more volatile as the 10y approaches 3% ...

Chart 20: Belly has proven much more volatile than the wings (as measured by 2w delivered vol, in %)



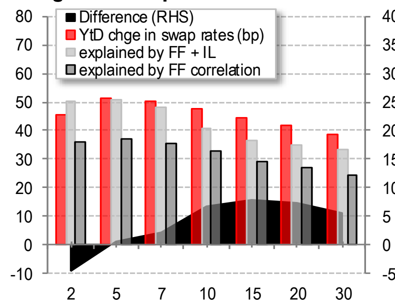
Source: Bloomberg, Santander.

Concerns about the possibility of inflation accelerating in the US in the months to come have increased substantially and the market is now particularly sensitive to anything that suggests that this risk might be materializing (or that the Fed could accelerate the pace of hikes to combat that scenario). Moreover, there have also been an increasing number of articles and comments in the media warning about the possible implications for risky assets if the 10y UST finally tries to break through the 3% level.

This has caused the belly of the US curve to become much more volatile over the past few weeks (indeed, recently the most volatile part of the curve, see Chart 20), with renewed demand appearing any time we approach that 3% mark (causing 5-10bp rally correction rallies), but also then gravitating back towards the higher end of the range whenever any bullish news or comments on inflation surface. We expect this behaviour to persist, at least for a few weeks, before the upward trend we expect for the second half of the year resumes.

… But we continue to expect some downward correction, at least relative to the wings

Chart 21: Move in FF futures and inflation does not fully explain YtD changes in swaps



Source: Bloomberg, Santander.

In our view, the key here is that it would take a clear hint that the Fed is keener to deliver a fourth hike (and we will not know that until at least the release of the next dot chart after the 20-21 March FOMC meeting) or a really evident risk of inflation accelerating faster than expected (and here we would focus on the wages data in this Friday's US Employment report and the 13 March release of core inflation figures) to try to breach these levels.

In the meantime, we continue to find (as we suggested last month) that the year-to-date change in monetary policy and inflation expectations explains the actual changes in nominal rates in the front end of the curve (and our analysis even shows that the front end could already be lagging behind in that price action, so the 2y could increase another 5bp just to catch up with the repricing in FF futures and IL swaps), while the belly (and the 15-20y tenors in particular, see Chart 21) still looks c.10bp higher than the level that would be consistent with the actual change in inflation and monetary policy expectations. Therefore, we believe those tenors are more likely to correct, at least relative to the wings of the curve.

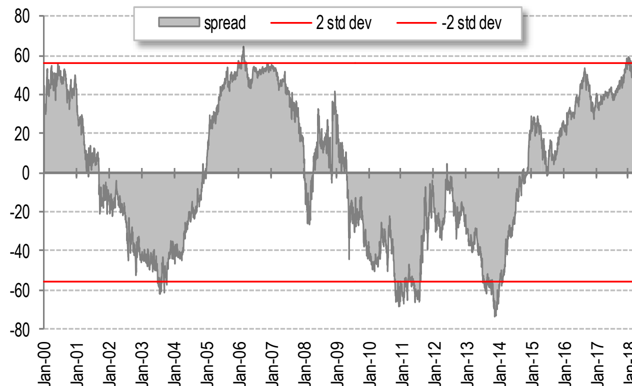
Under this assumption, we remain comfortable with our recommendation of receiving the belly in a 5s10s30s fly, which we opened last month (and is still close to our entry levels, so should still offer potential for gains). For

newcomers, however, we would now chose the 15y as the entry point for this tactical positioning. In particular, as shown in Charts 22 and 23, we find that a statistically solid relationship between the 15y and 5y5y has broken down and, after the recent sell-off, residuals have now reached two standard deviations (a level that has acted as an inflection point, statistically), suggesting that the 15y USD swap rate is too high compared to the current 5y5y USD swap rate.

- **Trade idea: Receive the 15y and pay 5y5y**
  Spread entry level = 7bp. Target level = 30bp. Stop loss = -5bp

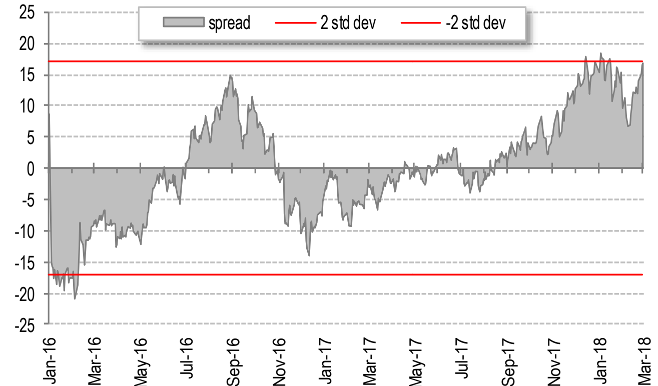
We open this trade at a spread of 7bp, targeting a return to the 30bp area that acted as the relative highs in 2016 and 2017.

Chart 22: 15y vs 5y5y– residuals (bp) of the linear regression for the 2000-2018 period (R2 = 94.2%)



Source: Bloomberg, Santander.

Chart 23: 15y vs 5y5y– residuals of the linear regression for the 2016-2018 period (R2 = 95.5%)



Source: Bloomberg, Santander.

Long-dated USTs' underperformance vs. swaps should continue due to the new supply dynamics

Last month, we highlighted that the outperformance of USTs over swaps during January looked unlikely to persist as it ran contrary to our view, and we positioned ourselves for a correction by selling the 30y UST in ASW. As we were expecting, the combination of less favourable supply dynamics (UST issuance has finally started to increase to finance the US tax reform) and a Fed that is gradually stepping out of the market has started to weigh on USTs. Indeed, we are nearing our target of 20bp in this tenor.

Here, we think that these underlying risks are still there and, once our initial target has been reached (it closed at 19.75bp on 26 February), believe there is room for further deterioration (and ASW widening). So, we are revising our target to the 30bp area .

- **Trade idea: Sell the 30y UST in ASW**
  Entry level = 18bp. Target level = 30bp.
  Stop loss = 12bp.

  The 30y UST ASW spread has returned to its end-December levels, which is what our trade recommendation of 2 February was targeting. As a result, we are now revising the target to 30bp (the closer end of the range seen between June and October 2017), and setting our stop loss at our previous entry level (12bp) to protect this positioning from net losses

Euro zone Economic Outlook

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Euro zone inflation rose to 1.5% YoY in 2017, mainly thanks to the energy component's contribution. We anticipate a more evident upturn in core inflation in 2018E, in a context of upside domestic risks.

Activity and spending in the Euro zone have clearly consolidated a recovery scenario of, and are even posting positive surprises. On the prices front, deflation fears appear to be over and, according to our analysis, price indicator details point towards increasing upward risks for inflation going forward.

Inflation consolidated at around 1.5% in 2017 and with notable changes in composition

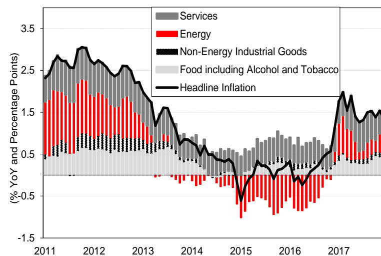
Euro zone inflation averaged 1.5% in 2017, clearly above the 0.2% in 2016, and with the corridor between the highest and the lowest rates among countries widening at the top. This rise in aggregate total inflation last year was mainly explained by more expensive energy (at 5.0% in 2017 vs -5.0% in 2016) and food (at 1.8% vs 0.9%) prices. In other words, the contribution by core inflation was quite limited, at an average of 1.0% in 2017 vs 0.9% in 2016. That said, this stabilization of core inflation 'hides' significant changes in its breakdown that evidence that risks are also biased to the upside for this component.

On the one hand, non-energy industrial goods (NEIG) prices moderated slightly in the period, standing at 0.39% in 2017 vs 0.44% in 2016, mainly as a result of the downward pressure from durable and semi-durable goods, which was more than enough to offset the rise in non-durable goods. On the other hand, the evolution of consumer prices in services is interesting, coming in at 1.4% in 2017 from 1.1% in 2016, still clearly affected by deflation in communications (-1.5%) and moderation in miscellaneous prices (0.7%), but supported by an intense acceleration in the housing (at 1.3%), recreation (2.1%) and transport (also at 2.1%) segments.

In fact, if we analyze all the minor components of the core CPI and its distribution, we find that an increasing percentage of the basket presents an annual rate that is finally in line with its historical average. At the end of 2017, 80% of the Euro zone's core inflation posted annual rates in a range of the average plus/less one standard deviation, rising from 60% in July 2017, to the detriment of the 16% still below average (down from 30% in July 2017). Among the major countries in the area, we highlight the case of Germany, where 34% of core inflation is already above its historical average.

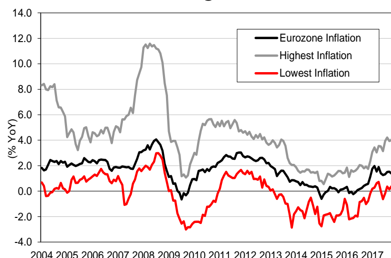
In sum, during 2H17 the Euro zone CPI breakdown saw significant changes, which are consistent with favourable growth momentum for the area. There are still clear downward pressures for consumer prices from some components with a relatively low weighting, but we can say that the bulk of the CPI basket is moving towards the right hand side of the distribution. At the end of the day, we believe this opens the door to the economic recovery translating more clearly into prices.

Chart 24: CPI and breakdown



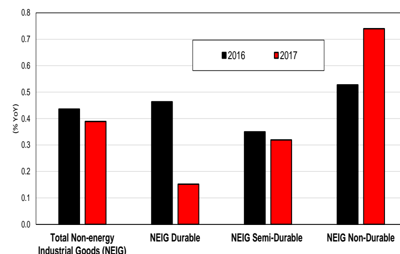
Source: Eurostat and Santander.

Chart 25: CPI among countries



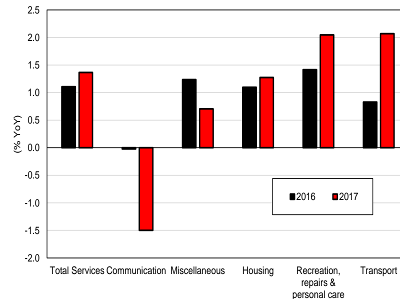
Source: Eurostat and Santander.

Chart 26: NEIG CPI



Source: Eurostat and Santander.

Chart 27: Services CPI



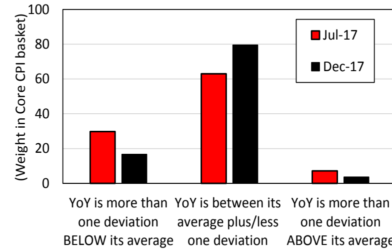
Source: Eurostat and Santander.

Prices: what to expect in coming months

2018 has begun with a decline in total inflation, to 1.3% YoY in January from 1.4% YoY in December, as a result of the significant moderation in the most volatile components: energy (at 2.2% YoY in January from 2.9% YoY in December) and food (1.9% YoY from 2.1% YoY). This was more than enough to offset the rise in core inflation to 1.0% YoY from 0.9% YoY on the increase in non-energy industrial goods (to 0.6% YoY from 0.5% YoY), while services inflation remained at 1.2% YoY.

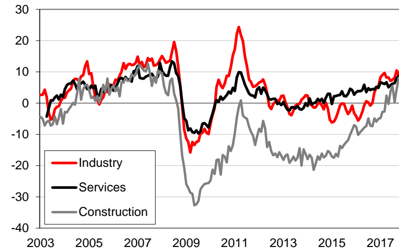
For the rest of the year, and taking base effects into account, we see energy prices driving a more moderate increase in headline inflation than was the

Chart 28: Distribution of core CPI



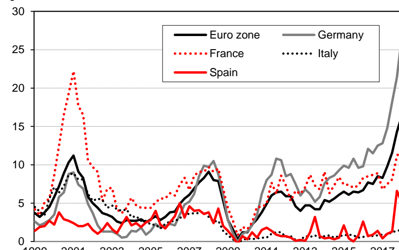
Source: Eurostat and Santander.

Chart 29: Companies' price expectations



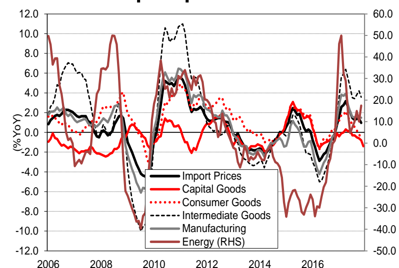
Source: EC and Santander.

Chart 30: Labour as a limit to production



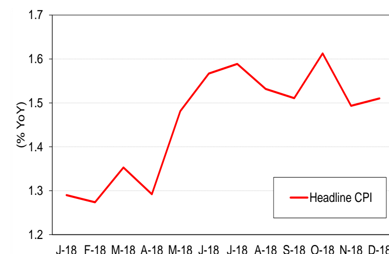
Source: EC and Santander.

Chart 31: Import prices



Source: Eurostat and Santander.

Chart 32: Headline CPI estimates



Source: Santander estimates.

case in 2017. In fact, at current oil prices in euros, we estimate that the energy component could average c2.0% YoY in the whole year, depicting a clear downward trend in 2H18E and becoming nearly neutral at the end of the period. This means that the performance of headline inflation should be very dependent on core inflation trends. We have not changed our view that risks in core inflation are clearly biased to the upside, judging by the positive flow of news coming from production, spending and confidence. All in all, we see supportive factors for Euro zone core inflation at around 1.5% YoY at the end of this year, driven by both non-energy industrial goods and services prices.

In this scenario, we estimate that headline inflation should follow an upward trend in 2Q18E, in any case, likely keeping closer to 1.5% YoY than to 2.0% YoY. In other words, total inflation could move in a relatively narrow range that, in our view, would not necessarily mean the absence of a reaction to it. In fact, inflation expectations could be particularly sensitive to a change in the CPI breakdown in favour of higher core inflation in 4Q18 due to its potential implications for ECB monetary policy strategy in 2019.

A scenario that is not free of risks, mainly to the upside

Regarding the domestic factors, the encouraging performance of growth and confidence is, in our view, a clear upward risk for consumer prices in coming months. The Euro zone's GDP growth is already above 2.0% YoY and is supported by favourable fundamentals than point towards this positive trend continuing in the coming quarters. The increase in demand is forcing companies to increase their staffing levels and the pace of employment creation is behind the recovery in households' income.

That said, the pressures for inflation coming from the labour market are still quite contained. Growth in productivity and the modest performance of salaries are keeping unit labour costs under control. But, as the surplus in employment supply diminishes, this situation may change and the shortage of employment in some activities could mean some pressure on wages. Indeed, this is already very evident in the German case, where employment is a factor which is limiting expansion in production. This is not a generalized phenomenon in the Euro area, unlike the improvement in companies' willingness to raise prices. In this sense, business confidence surveys in the region show an intensification of the upward trend expected for prices charged in the coming months in construction, manufacturing and services. In other words, we see a risk of companies' gross operating surpluses making a larger contribution to final prices due to a drive to improve their margins.

Moreover, note that the Euro zone has been importing inflation since the end of 2016. With the exception of capital goods, import prices are clearly increasing for the area, at c2.0% YoY in 2017, with trends in energy prices being particularly noteworthy (above 20% YoY). But, that said, this year could be different to 2016 due to the evolution of the euro exchange rate. Net-net, we estimate that the impact of import prices, taking into account the appreciation of the nominal effective euro exchange rate for the final demand deflator, could be rather neutral.

All in all, we maintain our view on the main trends for Euro zone inflation and its breakdown, and highlight the expected higher rates for core inflation against a background of domestic risks to the upside.

Euro Rates Strategy: Pause in sell-off as ECB policy expectations remain capped. Italy heads to the polls

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- **The solid growth outlook in Europe has yet to translate into higher inflation, thus capping the likelihood of changes in ECB policy and communication. As a result, the sell-off has run out of steam somewhat.**
- **We view the gradual rebuilding of term premia and the pull of US rates as the main sources of higher euro rates in the near term, and therefore favour curve steepening and US-EA widening trades.**
- **Following a widening correction, periphery spreads are going into March with prospects of lighter supply. In the case of Spain and Portugal, there is also a prospect of improved sovereign ratings.**
- **The major event risk for periphery are the Italian elections. Beyond near-term volatility, the main question is whether they result in any distancing between the government and EU institutions, which looks unlikely at this point.**

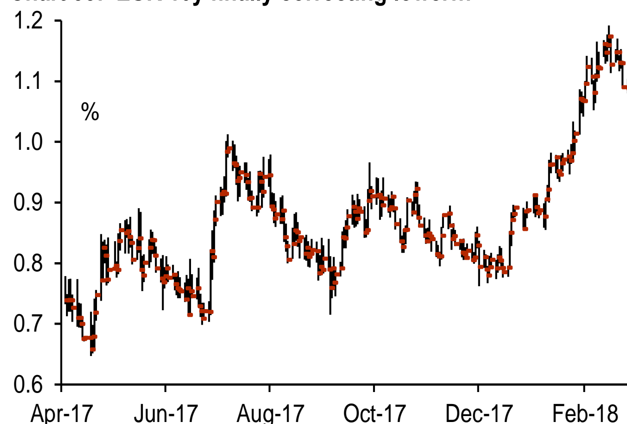
Rates market sell-off decelerates

The ramp-up in euro rates that began in mid-December showed increasing signs of losing momentum by late February. The correction, about 10 bp in 10y, has been fairly modest, but that follows the template set by previous sell-offs; the corrections tend to be much more gradual than the sell-offs.

The overall tone of data releases in the Euro area and US remains strong, though some of the sentiment indicators in Europe have corrected from historically high levels. Furthermore, as detailed further below, inflation figures remain quite subdued throughout the G7. The correction in equities markets from historically high P/E ratios undoubtedly also contributed to the less bearish rates market tone.

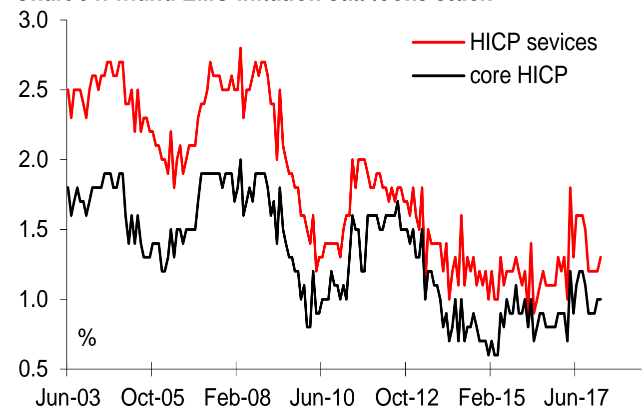
Looking at supply-demand balance specifically in the euro space, it seems possible that, due to the large volume of APP redemptions in April, the ECB might accelerate buying somewhat in March already, in order to smooth out that bump. Readers will recall that the monthly purchase amount (currently around € 30 bn) is meant to be roughly net of redemptions. The redemption total of € 22 bn in April is a multiple of recent months, so a bit of 'advance buying' makes sense to us.

Chart 33: EUR 10y finally correcting lower…



Source: Bloomberg, Santander.

Chart 34: …and EMU inflation still looks stuck



Source: Eurostat, Santander.

It still looks early to go long inflation again

Since the beginning of this year, most measures of the Euro area's market-traded inflation[1] have moved sideways. Shorter-dated ILS/BEI have actually corrected lower, recently, reflecting deceleration in ex-tobacco HICP y/y inflation.

The Euro area's final January ex-tob. HICP figure came in at about 1.25%. That measure of realised inflation has been in a 1.2% to 1.5% range since the May 2017 figure and decelerated in December and, again, in January. The February estimate based on the flash release of all-items HICP suggests a year-on-year rate of 1.2%, with core stuck at 1%.

Strong economic sentiment suggests faster inflation for the Atlantic Rim, at some point. Euro area core inflation is still lagging its historically significant precursors by a greater extent and for a longer period than is typical. Should that be bullish or bearish for market-traded inflation? After such a protracted delay, we do not think the market will take chances and try to anticipate accelerating inflation too much, barring a sudden drop in the euro or a spike in oil.

In absolute terms, the fact that the Euro area 5f5y ILS is still well below 2% (1.7-1.75%) suggests lingering scepticism about a return to pre-crisis consumer price dynamics. We could argue that it is a relatively cheap level but, given the data above, the timing feels too early. The very gradual recovery in underlying (core and services) prices, plus the dynamics of more erratic components (food and energy) suggest that year-on-year rates will not rise substantially until well into Q2-18. Before then, receiving inflation (paying fixed) in ILS is unlikely to show a positive carry.

Whereas we are wary of an outright long in euro ILS, we believe there is an **interesting opportunity along the term structure of traded inflation**. The pick-up in the 5f5y area, compared to short-term inflation swaps and longer-term ones, looks low, historically (Chart 35). Paying 5f5y fixed inflation against receiving the actual inflation looks attractive to us. The curve, overall, is likely to flatten once we, eventually, see an acceleration in year-on-year figures, but **expect more term premium to be built into the 5f5y – 5y spot spread** (currently around 30-35 bp) r**elative to that in the 15f15y – 5f5y spread** (currently 45-50 bp).

Trade Idea:

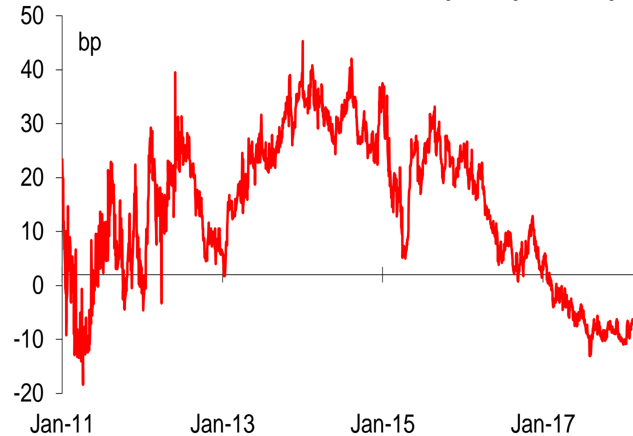
Pay 5f5y fixed vs. inflation
Receive 5y and 10f5y inflation vs. fixed

The current spread is -7 bp, with a target of +10 bp and a stop at -15 bp.

In relative value terms, the difference between seasonally-adjusted BEI in OAT€i or SPGB€i vs ILS has shrunk, in recent weeks and months, but it remains positive. Therefore, it is still possible to receive a higher pay-out by asset swapping (ASW) inflation-linked bonds with the inflation payment fixed through ILS than by ASW on nominal bonds from the same issuer. Our traders continue to observe flows there and we believe they are likely to continue.

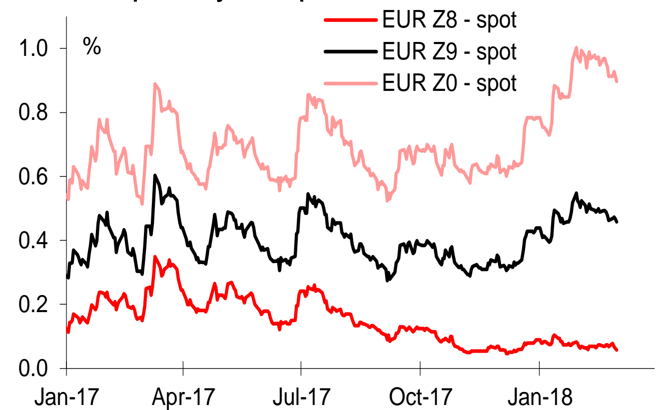
[1] This includes inflation-linked swaps (ILS) and the break-even inflation (BEI) on inflation-linked bonds.

Chart 35: Euro-area ex-tob ILS barbell 5f5y vs. 5y & 15f15y



Source: Bloomberg, Santander.

Chart 36: Euribor futures' discount of future hikes has topped out – we expect very little upside



Source: Bloomberg, Santander.

ECB will resist the suggestion that tightening can occur before reflation is entrenched

Not long after this monthly is published, the ECB's Governing Council (GC) will meet (Thursday, 8 March). Since the GC last convened, the euro currency value has traded sideways, despite comments, back in January, that Draghi had not been sufficiently dovish for the FX market. That said, the trade-weighted euro is still about 9% above early-2017 levels. Also, oil inflation has decelerated, since then, and consumer price dynamics have shown no sign, overall, of accelerating. There will be little reason, in terms of data flow and economists' opinions, to apply anything beyond tiny tweaks to the ECB's staff forecasts.

Given the lack of significant change on the macroeconomic and currency fronts, the only reason to expect any evolution in the ECB's rhetoric is the fact that several influential GC members have been publicly agitating for it. This has been evident in public statements and the January meeting account. We think that the policy statement will remain unchanged but believe there is a better than 50-50 chance that, in the course of the press conference, Draghi will confirm that discussions about the Asset Purchase Programmes (APP) after September and modifying the ECB's 'communication' have begun. We do not expect any firm conclusions to have been reached, yet, but the direction of travel should be towards: a) the rapid wind-down of the APP before the end of 2018; and b) a more explicit statement to the effect that **rates will not rise before H2-19, and then *only* if the "three conditions"[2] regarding the inflation target have been met.**

EUR rates implied that the ECB will begin to tweak the Deposit Rate higher in Q1-19 (now shifting to Q1) and that it will be at 0% by the end of the same year. From a bearish standpoint, any evolution in ECB communication can be viewed as a drift towards eventual 'normalisation', but our impression is that the dovish majority led by Draghi will fight a rear-guard action against that, just as it did against the currency strength. Given that pricing and our expectation for the March policy meeting, **we believe that the ECB will have a neutral to slightly dovish impact on the direction of EUR rates, over the next few weeks.**

[2] The three, deliberately vague, criteria to be met are that: 1) the below-but-close-to-2% target must appear to be achievable in the medium term (not just a temporary spike in HICP), 2) the forecast must reflect "confidence in the degree of convergence" to the target, and 3) the target can be met even if the policy stance is tightened.

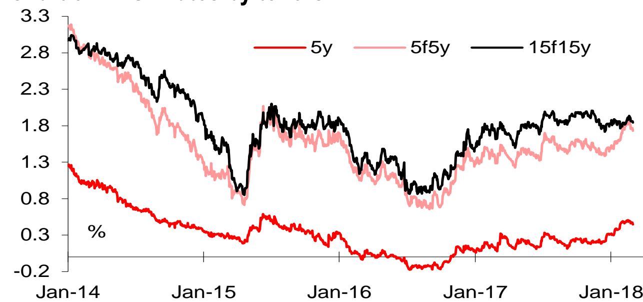
Directional positioning: Steepening and US-EA spread widening

Given that, in the Euro area, monetary policy, flows and inflation seem unlikely to propel rates higher from current levels, in the next few weeks, where is the highest bear-market risk for euro rates? Broadly speaking, we see two components of higher rates that can continue to exercise some pressure: a) greater risk premia at the longer end and b) the upward pull of US rates. If we are correct about these directional factors being in the lead, it follows that directional positioning should concentrate curve steepeners and US-EA spread widening.

Along the euro rates term structure, in both nominal and real terms, there is a decent amount of normalisation priced into the 0 to 5y period and 5y to 10y segment, too. However, the longer end has not incorporated as much risk, as the non-overlapping forwards show (Chart 37).

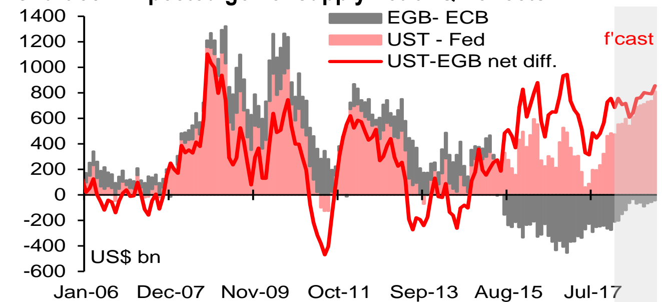
We recommended a 10s30s steepener late last year and 'added to it' in late January, after the curve had flattened. We still like that trade and also think it would work as well in the forward space (so, a 15f15y – 5f5y steepener) for investors that do not have the position. Note that, net of the ILS element, 'real' IRS show a nearly 100 bp pick-up from 5y spot to 5f5y, while the 15f15y is nearly 40 bp below the 5f5y.

Chart 37: EUR rates by tenors



Source: Bloomberg, Santander.

Chart 38: Expected govie[3] supply net of QE effects



Source: Bloomberg, Santander.

The US-EA spread widening trades have essentially been predicated on the significant lead the US has shown in the process of monetary policy normalisation. The Fed began to hike rates in 2015 (repeatedly in late 2016), while the ECB is unlikely to start until well in 2019. The Fed ended QE in 2014 and began reducing its holdings in 2017. The ECB is still accumulating EGB holdings and seems unlikely to begin reducing its holdings before 2020.

This dynamic will only be exacerbated by the substantial fiscal loosening implied by the combination of tax cuts and bi-partisan agreement on expenditure in the US. Late last year we recommended a 5y US-EZ spread widener, which has now moved by 25 bp in to the money. That trade still makes sense but, taking into account carry considerations, we would shift to slightly longer maturities to take advantage of a better carry. Thus, take profit on the 5y spread widener and enter into a 8y spread widener (the carry is a couple of bp better per year).

Trade Idea:

Pay USD 8y fixed
Receive EUR 8y fixed
The current spread is -194 bp, with a near-term target of -210 bp and a stop at –185 bp. Carry is positive at nearly 1 bp per month.

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[3] Supply includes tradable UST Treasury debt for the US and Euro area €-denominated general government debt. QE effects include the UST portion of the Fed's balance sheet reduction and the Eurosystem's holdings of public-sector securities. The two Euro area aggregates do not match exactly but, on this scale of data, the difference is arguably not significant.

Periphery widening correction makes for cheaper entry levels

Following a protracted period of outperformance, periphery EGBs have experienced two-three weeks of correction, with 10y spreads over Bunds about 10-15 bp above their early-February narrow points. Besides being a normal market correction, we think there are three factors at play in this underperformance:

a) Although the timing has not been precisely synchronised, the widening is partly a reflection of a **broader 'risk-off' move** (also in stocks and periphery bank CDS) that was itself partly a reaction to the rather sharp rise in G10 rates.

b) **Heavy supply** has arguably played a role. Although the figures show that the large sovereign bond syndications across the periphery have been well-received, together with the regular auction schedule they have amounted to substantive flow. January and February, together, saw over € 60 bn of 10y+ periphery supply, compared to just under € 45 bn in the years from 2014 to 2017.

c) Imminent **elections in Italy** have had a direct impact on BTP valuations which, arguably, has had an indirect effect on other periphery EGBs. We discuss this phenomenon separately, below.

The bottom line is that, for instance, implied cumulative default probabilities are back into 20%+territory for periphery issuers. Given some of the aforementioned considerations, though, there is some uncertainty among market participants regarding the exact timing of being long periphery again As far as supply goes, March and April should see a deceleration. We cannot really base one market forecast on another but, as we mention above, a fair amount of policy normalisation is incorporated in market prices (though not all). The political risk of Italy's elections clearly will take time to play itself out. Against that, however, we note that March features some important appointments on the sovereign ratings review front.

Further supportive ratings reviews are likely in March

Sovereign ratings changes have been a key driver of periphery spread performance, in recent months. Several rating reviews are scheduled for March, including for Italy (Fitch & Moody's on 16 March), Spain (S&P on 23 March), Portugal (S&P on 16 March) and Greece (Moody's on 30 March).

Moody's rating for **Italy**, at Baa2, is one notch below S&P and DBRS, so the negative outlook could be changed to positive. Fitch downgraded Italy in 2017 and it seems unlikely they will reverse themselves so soon. Both rating agencies will also be digesting the meaning of the electoral result, so '**no change' looks like the path of least resistance**, in March.

An upgrade of Spain's rating by S&P on 23 March looks quite probable to us given that they have had a positive outlook since last year but no actual upgrade since 2015. Furthermore, their BBB+ rating is below both Fitch and DBRS (both A-/A L).

An upgrade of **Portugal by S&P** is a minority outcome, in our view, as the agency upgraded it in September 2017 and the rating, at BBB-, is in the middle of the range for that issuer. We see a stronger **possibility of the outlook being changed to positive**.

Near-term BTP risk linked to elections

According to political experts, Italian Parliamentary elections, on Sunday, 4 March, are most likely to result is a hung parliament, with no single party or electoral coalition holding a majority in both chambers. This would be

followed by a fairly protracted (upward of 2-3 months) period of uncertainty and potential 'trading' between various parliamentary groups, similar to what happened after the 2013 elections. Back then, the market reaction to political splintering was quite negative, with the 10y BTP-Bund spread widening by about 70 bp in the following few weeks.

However, since 2013, the Italian economy has performed considerably better and the coalition / minority governments that followed were even able to implement some politically difficult reforms. Similarly, Spain has experienced quite strong economic growth despite the double vote (Dec 2015 – June 2016) and minority government in place since then. This all suggests that BTP spread volatility following the Italian elections is likely to be considerably less than after the 2013 vote.

We believe that investors are likely to focus more on the degree of commitment to the EMU of any new government than the break-down of the popular vote, barring some massive upward surprise in the share of vote for parties that support any distancing from the EMU. We believe that, ultimately, it would be self-destructive for any party or politician to undermine the value of large swathes of Italian savings.

Overall, **the significant pick-up offered by BTPs over SPGBs and PGBs already incorporates substantial electoral risk**, though not a worst-case scenario. In 10y terms, BTPs currently trade 55 bp above SPGBs and 20 bp above PGBs. It might seem tempting to be neutral, or even short BTPs until there is more clarity on the political front. We think the market reaction might prove a bit too fast to allow any value capture *after* the vote. We do not recommend a trade here, at this time.

SPGB spreads tighteners look like a good trade, in risk/reward terms. Specifically, in the longer maturities, the 2046 SPGB-Bund spread is barely changed from our recommended entry level and we would keep that trade on. Additionally, since the term structure of periphery EGB spreads over Bunds remains rather steep, on a more strategic basis, we think it makes sense for those investors who are able to do so to buy spreads in forward space. For instance, 10y SPGB-Bund spread is currently around 85 bp, comparing the 2028 bonds. The spread on (interpolated) 5y (March 2023) maturities is 50 bp. A 5f5y spread is roughly at 120 bp.

Trade Idea:

Buy SPGB 1.4% Apr-2028
Sell Bund 0.5% Feb-2028

The current spot spread is 87 bp and five years forward the spread is 121 bp. We target a forward spread of 100 bp, but with a tighter stop-loss than for recent trades, recognising volatility, at 135 bp (in forward terms).

Euro government bond supply: YTD update

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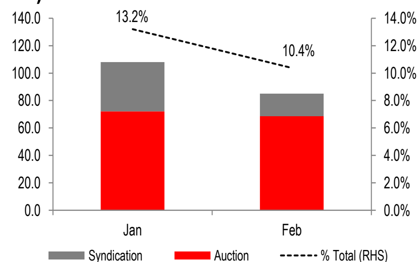
2018 EUR govie issuance surpasses the 23% mark

Year-to-date, the Euro area as a whole has covered more than 23.2% of its total average financing requirements for 2018.

At the end of February, EUR issuers have sold €190.1bn in bonds via both ordinary auctions (€140.6bn) and syndicated deals (€49.5bn), representing 23.2% of the issuance target of €819bn we estimate for 2018. As seen in Chart 39, bond auctions decreased slightly in February, as did syndications, perhaps due to the recent turmoil in markets around the globe.

Chart 39: Monthly EZ supply – YtD (€ bn)



Source: Bloomberg

In terms of YTD completion rates by country, all the Eurozone issuers, bar the Netherlands (at 7%), have surpassed the 10% mark. This month, Portugal, Ireland, Austria and Belgium lead the way, having already completed 35%, 33%, 31% and 31% of their 2018 issuance objectives, respectively. Spain is not that far behind, at 29%, while Finland is in sixth place, at 27%. The other Euro area issuers above the 20% mark are Italy and France, with 23% and 22% completion, respectively. For its part, Germany is above the 10% level, at 19% (see Table 6).

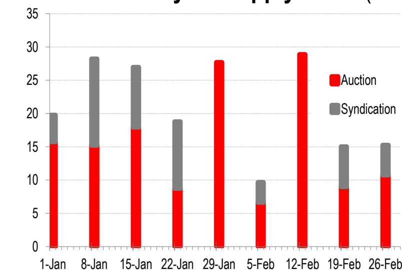
Table 6: Total issued in EZ in 2018, by country (updated as at 28 February)

	GE	FR	NE	AS	SP	BE	PO	IT	IR	FI	TOTAL EZ (€bn)
YtD auctioned issuance	29.5	43.3	1.9	2.8	20.0	0.0	1.3	40.6	1.3	0.0	140.6
YtD syndicated issuance	0.0	0.0	0.0	4.0	16.0	9.5	4.0	9.0	4.0	3.0	49.5
YtD Issuance	29.5	43.3	1.9	6.8	36.0	9.5	5.3	49.6	5.3	3.0	190.1
2018 programme	155.0	195.0	29.0	21.5	126.3	31.0	15.0	219.0	16.0	11.0	818.9
% completion (RHS)	19%	22%	7%	31%	28.5%	31%	35%	23%	33%	27%	23.2%

Source: Bloomberg, EZ countries' debt agencies

In term of numbers, Euro area issuers have now placed around €190bn. This month, Italy is at the forefront, with €49.6bn of BTPs, CTZz and inflation-linked BTPs. France comes in second with €43.3bn of debt issuance. Spain is issuing faster than ever before, reaching the third place with €36bn, and Germany is a distant fourth, with €29.5bn of DBRs, OBLs and BKOs. The rest of the issuers are below the €10bn mark (Table 6).

Chart 40: Weekly EZ supply – YtD (€bn)



Source: Bloomberg, EZ countries' debt agencies.

With regard to weekly averages, Eurozone issuance is at €21.1bn per week through the end of February. The largest volume of supply was seen in the week commencing 12 February, with €28.9bn placed, whereas the week that started on 5 February saw the lowest volume placed, just €9.6bn, not including Greece's €3bn 7y bond syndication (Chart 40).

Table 7: YTD issuance completion vs. historical data

	2013	2014	2015	2016	2017	2018	Aver 13-17
GE	14%	14%	16%	12%	12%	**19%**	14%
FR	15%	15%	15%	15%	17%	**22%**	16%
NE	13%	16%	12%	5%	19%	**7%**	13%
AS	7%	8%	9%	19%	14%	**31%**	11%
SP	19%	20%	19%	19%	18%	**29%**	19%
BE	15%	22%	20%	16%	24%	**31%**	19%
PO	45%	28%	36%	29%	25%	**35%**	33%
IT	13%	13%	17%	13%	15%	**23%**	14%
IR	33%	32%	47%	41%	28%	**33%**	36%
FI	7%	33%	7%	12%	16%	**27%**	15%
TOTAL EZ (€)	**15%**	**16%**	**17%**	**15%**	**17%**	**23%**	**16%**

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

As shown in Table 7, Euro area issuers have now covered 23.2% of their 2018 issuance requirements, on average, outstripping both the 2017 completion rate (17%) and the average for the last five years (16%) at the same point in the year. At the end of February, Austria, Belgium (both at 31%), Spain (29%), France (22%), Italy (23%) and Germany (19%) have set new record highs in terms of completion rates of the last five years. And the rest –including the Netherlands, Portugal, Ireland and Finland– are issuing within their maximum-minimum ranges over the last five years.

When comparing 2018's to last year's completion rates, at the top, Austria is exceeding its 2017 average by 18pp. The rest, bar the Netherlands (which is lagging behind –by 13pp–its performance a year ago), are also issuing at a faster pace than in 2017. The cases of Belgium and Finland are noteworthy, as they have only placed debt through syndications, covering around one-third of their funding needs in a couple of months.

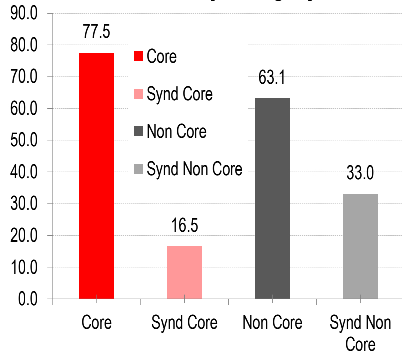
Periphery countries ahead of core counterparts

As seen in Chart 41, periphery issuers have surpassed the core countries as we progress further into the final month of the first quarter. At the end of February, periphery issuance accounts for 50.6% (vs. 53.8% in January) of the total, which is equivalent to €96.1bn, while core supply makes up the remaining 49.4% (vs. 46.2% previously), or €94n.

In terms of amounts issued so far via syndication, as in previous years, non-core Euro area countries have placed twice as much as their core counterparts (€33bn vs. €16.5bn), while core countries have auctioned 1.23x more than the periphery so far this year (€77.5bn vs. €63.1bn).

At the same point of 2017, the periphery countries had issued €27bn via syndicated bonds and auctioned €69.2bn, for a total of €96.2bn, , compared to an almost identical €96.1bn (€63.1bn through auctions and €33bn via syndication) so far in 2018. For their part, the core Euro area countries issued €100.2bn in the first two months of 2017, which is slightly ahead of the €94bn placed in the same period of this year.

Chart 41: Issuance by category – YtD

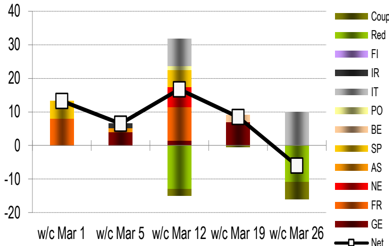


Source: European Commission, EZ countries' debt agencies, Bloomberg, Santander

Supply dynamics: Positive net Euro area supply in March

In March, we expect more than €70bn in new auctions with, on our numbers, Italy, France, Germany and Spain set to issue €18bn, €18bn, €12.5bn and €10.5bn, respectively. Austria might introduce a new benchmark through a syndicated bond deal like last year. The Netherlands, Portugal, Ireland, and Belgium are scheduled to sell bonds this month, while Finland perhaps might undertake primary market placements. All this supply will be partly offset by €24bn in redemptions from Germany and Belgium, and €7.5bn in significant coupon payments (mostly from Belgium) during the month. Consequently, net EUR issuance is set to be in positive territory in March (Chart 42).

Chart 42: Expected net EUR bond supply (€bn)



Source: Bloomberg, Santander.

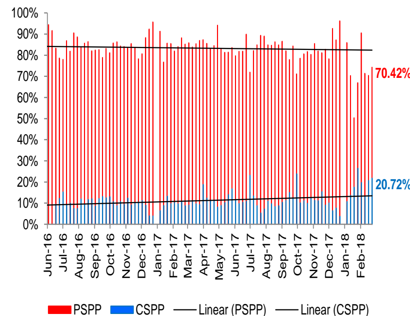
Update on the ECB's EAPP

The ECB's latest report on its Extended Asset Purchase Programme (EAPP) holdings (published on 26 February) –including the purchases settled as at 23 February– shows €2.34trn of assets accumulated since the programme began in 2015. According to that report: the PSPP portfolio has a total of €1.93trn in Euro area govies and supras, accounting for 82.3% of the ECB's monetary policy portfolio; CPBB3 holdings amount to €246.8bn, or 10.6% of the portfolio; the CSPP totals €140.8bn, or 6% of the portfolio; and the ABSPP now stands at €25.3bn, representing the remaining 1.1%.

The overall weekly figures (€5.1bn) seem to confirm that the new pace of €30bn/month (down from €60bn previously) has not translated into a proportional 50% decline distributed evenly among the different programmes. Rather, the PSPP purchases have fallen more markedly (averaging 72.5% in the first eight weeks of the year, down from 84% since the onset of the programme), to the benefit of the CSPP (which has averaged 17.9% since January, up from 11% since this programme started back in June 2016). Also, the figures presented yesterday unveil that, following quite an erratic January, the pace of PSPP and CSPP purchases seems to be stabilizing (at around 70% and 20%, respectively), while the shares assigned to the CBPP3 and ABSPP seem to be more dependent on primary issuance.

By country, the latest information available is a breakdown of the PSPP debt security holdings published by the ECB on 5 February, which we commented on in detail in our MMD report the following day. In summary, the figures show that January public sector purchases totalled €20.9bn (a €25.3bn decrease vs. December), €18.8bn of which were govies and from agencies, with the rest being supra debt (€2.1bn).

Chart 43: Share of weekly EAPP purchases for the PSPP & CSPP, with linear trend line



Source: ECB, Bloomberg, Santander

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- **Irish border issues have long been viewed as a key obstacle to a smooth Brexit transition …**
- **…and the publication of the EU's draft Withdrawal Agreement for the UK, detailing the EU's preferred 'fall-back' scenario for Northern Ireland, now questions the ability to secure a transition-period deal**
- **With the case for tighter monetary policy in the UK already questionable, in our view, we argue that this latest Brexit setback offers further motivation for the MPC to hold fire at its 10 May meeting.**

Brexit and the MPC: Could May's 'No' mean a no-go for May?

Questions relating to the Irish Border and the EU Customs Union have long been viewed as key obstacles for the UK's Article 50 process. This follows the UK government's stated intention to pursue an independent trade policy post-Brexit, raising the prospect of a 'hard border' developing across either the island of Ireland, or, alternatively, between Northern Ireland and Great Britain, and in the process forcing a major constitutional shift for the UK as a whole. The inconclusive outcome of the 2017 General Election –and the Conservative Party's resulting dependence upon the support of the Democratic Unionist Party in order to maintain power– is typically seen to have simply added a further layer of complexity for those charged with finding a compromise solution.

But, with the publication of the EU Commission's draft Withdrawal Agreement for the UK suggesting a hardening of the EU's bargaining position with regard to Northern Ireland –specifically by detailing the 'fall-back' option which would exist should more specific efforts to avoid a hard land border across the island of Ireland fail– the true scale of the challenges to a smooth Brexit process appears to finally have been laid bare.

Already, UK Prime Minister Theresa May has described the EU's draft agreement as presenting a set of conditions to which "no UK Prime Minister could ever agree", given the risks presented to the common market which exists across the UK. With the ability to agree upon a post-Article 50 transition deal at the EU Council's 22/23 March summit now looking more doubtful, we question how this renewed Brexit uncertainty may influence the outlook for the Bank of England's Monetary Policy Committee (MPC), and the market's apparent expectation of a 25bp increase in Bank Rate at the Committee's 10 May policy meeting. In our view, the fundamentals of the UK economy already question the need for a higher level of Bank Rate, and we believe that this aggravated level of uncertainty surrounding the Brexit process –and the ability to agree upon a transitional phase between UK and EU relations from 2019 onwards– presents a further key argument for caution on the monetary policy front.

Divorce 'deal' was already shrouded in doubt

As stated above, the renewed controversy around the Irish border issue follows an apparent hardening of the EU's negotiating position, as revealed by the protocol covering Irish issues contained in the draft Withdrawal Agreement. Should the UK not remain in the Customs Union after exiting the EU, and should the UK government fail in its objective to negotiate an agreement that would result in free and frictionless trade across the Irish land border, the draft Withdrawal Agreement outlines the 'base case' which would operate from the EU's perspective. In essence, this base case

involves Northern Ireland effectively remaining part of the EU Customs Union for the purposes of goods trade –with its trade policy and disputes falling under the auspices of the European Court of Justice (ECJ)– while the need to promote North-South co-operation as a whole is seen to rely upon the continued use of large areas of the EU Single Market and legal legislation.

Certainly, the language used in the EU's Irish protocol would appear to set the UK government a demanding task as regards creating the type of frictionless trade across the island of Ireland that would be deemed acceptable from the EU's perspective. The protocol reiterates calls not only for an avoidance of a hard border, but also of "any physical infrastructure or related checks and controls", seemingly reducing the options available to the UK government as to how the new trade arrangements may be implemented in practice. But, in our view, the details of the divorce 'deal' struck between the UK and the EU last December (the so called "Joint Report") already presented the potential for a disagreement over matters relating to the Irish border –or at least a difference in interpretation of the middle-ground achieved– to frustrate the Article 50 process overall.

The potential stumbling points were not hard to identify…

These concerns related to several, inter-linked aspects of the Joint Report text, with the key stumbling points, in our view, being as follows:

First, the UK government's stated intention of resolving the particular difficulties relating to the Irish border through the overall, final agreement achieved on future EU-UK relations (the so-called 'first scenario') suggests that details around any contingency planning for the Irish border issue may be slow to emerge (should a broader agreement fail to be achieved). In essence, with the UK government declaring its intention to leave the Customs Union and secure a comprehensive, bespoke trade agreement with the EU, the Irish border question would remain part of the broad stream of negotiation, which could, in theory, run for several years after the UK formally leaves the EU.

Second, where details around the UK government's contingency plan for crossings over the Irish border have emerged (the second scenario), these appear to place significant faith in the ability of technological applications to reduce (if not remove entirely) the need for any hard, physical customs infrastructure to exist at the land border. Given the largely unproven nature of this technology, the different parties involved may hold differing levels of faith in its ability to achieve the stated goals. In turn, this questions the ability to secure agreement on the specific proposals required, should the first choice or scenario aimed at solving the border issue fail to be achieved.

Third, and perhaps most contentiously, the scope of the text which featured in last December's Joint Agreement, relating to the 'fall-back' option for Northern Ireland that would come into operation should the first and second scenarios outlined above not be achieved, is also open to interpretation. In the absence of any broad or specific agreement on the Northern Ireland border issues, the UK government has agreed to maintain full alignment with EU Single Market and Custom Union rules, but only to the extent required to "support North-South cooperation, the all-island economy and the protection of the 1998 (Good Friday) agreement". As such, we believe that the extent of the alignment with EU regulation required of the UK under this third scenario is unclear, and may, in theory, relate to a handful of key industries, such as transport and utilities, rather than the full extent of the EU Single Market and Customs Union law.

…and the Withdrawal Agreement has moved to fill the gaps

In essence, the protocol on Ireland/Northern Ireland contained in the EU's draft Withdrawal Agreement for the UK now seeks to remove the ambiguities which exist around the scope and detail of this fall-back option (the third scenario).

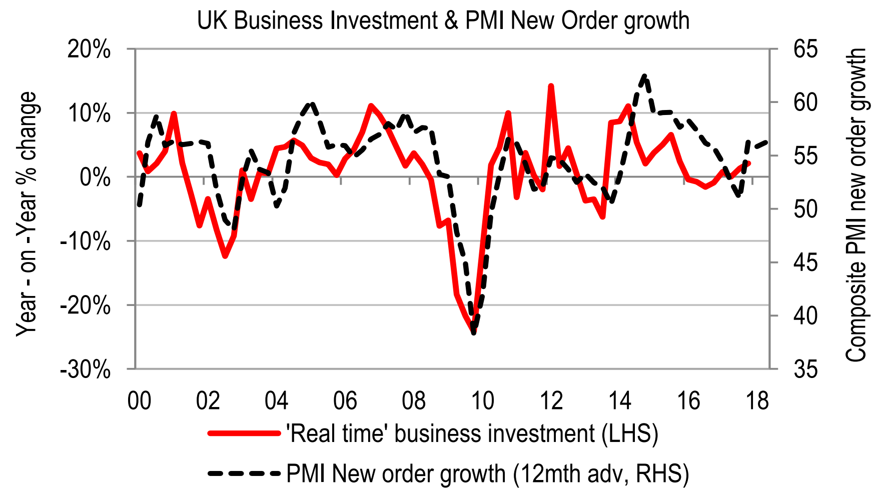
Again, the text reiterates the need to avoid a hard border, including any physical infrastructure, checks and controls. But the protocol breaks new ground by expressing the desire to create a common regulatory area across the island of Ireland to cover goods trade once the UK leaves the European Union, an objective that did not explicitly feature in last December's Joint Report. Moreover, whereas ambiguities may have previously existed around the areas to which the UK's "full alignment" commitment for Northern Ireland related, the Withdrawal Agreement declares the need to maintain cooperation across the island of Ireland with regard to "the full range of political, economic and societal and agricultural contexts". In turn, this cooperation would rely to "a significant extent on common Union legal and policy frameworks", effectively implying the use of the Single Market rulebook, overseen by the European Court of Justice.

Customs Union divide has raised the political stakes

In essence, therefore, 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– has 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. Given that this represents only a fall-back option, and that the issue of the Irish border has long been viewed as a critical obstacle to a smooth Brexit transition, it is perhaps still questionable whether the publication of the draft Withdrawal Agreement is an entirely 'new' or unexpected development. But, at the very least, the ability to move towards a compromise agreement on these issues ahead of the 22/23 March EC Council meeting –and make sufficient progress such that agreement between the EU and UK with regard to a post-Article 50 transition period can be approved– must now be viewed as doubtful.

We believe the achievement of such a transition-period agreement at the March EU Council meeting has previously been the consensus expectation for most investors. In addition, the potential for the Irish border issue to create wider political stress across UK markets has also likely increased following the Labour Party's recent shift in Brexit policy, with the UK's continued membership of a Customs Union with the EU (subject to certain conditions) now being Labour's favoured option. Speculation of a possible Parliamentary defeat for the Prime Minister on the issue of the Customs Union had arisen even prior to the publication of the EU Withdrawal Agreement, and while some in the market may view such an outcome as an indirect route to a Soft Brexit outcome, others would regard the prospect of a Conservative Party leadership challenge as the more likely consequence of such a Parliamentary defeat.

Chart 44: UK business investment has stalled, and the PMI surveys suggest a major recovery is unlikely to emerge anytime soon



Source: ONS, IHS Markit, Santander.
Note: Chart shows a real time measure of business investment expenditure, based on the preliminary estimate of the annual rate of change. The PMI new order growth series is a GVA-weighted measure of the new order / new business subcomponents of the manufacturing and services PMIs, including data up to January 2018**.**

MPC may find that patience is a virtue

Taken as a whole, therefore, political risks within the UK appear to be on the rise once again, and with a smooth Brexit transition now looking less certain, we would also regard the case for a tightening of UK monetary policy as increasingly doubtful.

The MPC, of course, has wasted no opportunity to stress that any major disruption to the UK's trade framework post-Brexit would impact both the level of demand and supply growth across the economy, with uncertain implications for the longer-term inflationary outlook. But, given the likely impact of a disorderly Brexit process upon the UK economy, we believe that even a small increase in the perceived risk of such a scenario may influence business confidence adversely, and that policymakers should avoid contributing to uncertainty in the meantime.

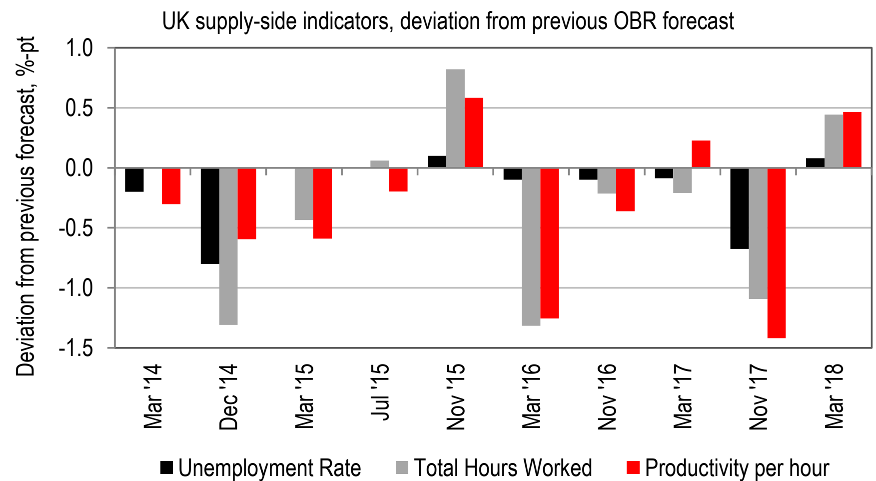
As stated above, we already view the case for higher UK rates as questionable, and believe that the balance of the UK data released since the turn of the year supports our view. Recent revisions show UK GDP growth to have slowed, rather than accelerated, in Q4-17, with household wage and salary income growth proving especially weak over the quarter as the increase in the number of hours worked across the economy declined. Measures of business confidence have typically weakened, while business investment stalled in Q4-17, with the level of investment now just 0.1% above the Q1-15 level. The Bank of England's recent communications have been keen to stress the apparent differential between the subdued level of investment expenditure and surveyed measures of business activity. But Chart 44, using a simple weighted measure of the new order / business series of the manufacturing and services PMIs, suggests that the size of this anomaly should perhaps not be exaggerated, questioning the underlying strength of investment intentions.

Critically, we remain unconvinced by the prospects for a sustained acceleration of wage growth to develop through 2018, and also believe that any upturn in measures of domestically-generated inflation would also now occur from a weaker level than previously expected. Although the recent communications from MPC members have typically downplayed the

significance of the reported rebound in productivity growth in H2-17, we argue that the recently improved measures of supply growth / spare capacity offer further reason, and indeed scope, to leave UK monetary policy unchanged. Chart 45, which charts the performance of the headline unemployment rate, total hours worked and labour productivity series relative the Office for Budget Responsibility's forecasts, shows each of these supply-side indicators to have surpassed expectations since the publication of last November's Budget Statement, providing a clear contrast to the conditions seen in the lead-up to the November 2017 rate hike.

Once again, several more positive surprises in these indicators will likely be required before a change can occur within the MPC's core view of the economy's supply potential. But, given the renewed obstacles to a smooth Brexit transition, the recent weakness of UK activity data and signs of a recovery in the UK economy's supply potential, we believe that patience is likely to prove a virtue for the MPC, and argue against any tightening of its monetary policy in the months ahead.

Chart 45: Performance of key supply-side indicators relative to OBR forecasts



Source: OBR, ONS, Santander.
Note: Chart shows the performance of the headline unemployment rate, the change in total hours worked, and labour productivity (per-hour basis) between the publication of various Budget Statements, and relative to the OBR's forecasts. The sign on the total hours worked series has been reversed, so that a negative figure represents a larger increase than implied by the OBR forecast. Negative figures represent a worse supply-side performance relative to OBR expectations.

UK Rates Strategy: Some flattenings are more durable than others

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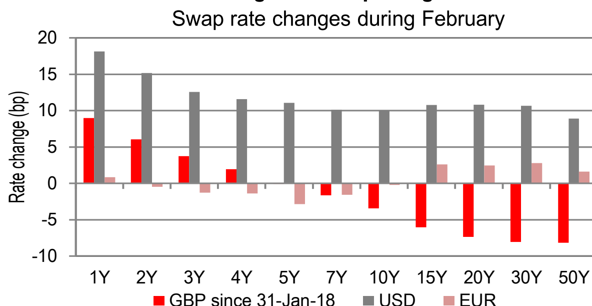
- **Outright rates in the UK have been flattening across the board**
- **The very shortest dates (sub-2y) have been under most pressure…**
- **…and we consider BoE hike pricing to be excessively front-loaded**
- **Overseas rates will likely continue pressuring the UK's upward**
- **Libor-Sonia spreads re-widened in parallel, and could flatten next**
- **Long-end flattening could go even further, towards the inverted profile which was typical in the pre-crisis era**
- **Gilt spreads' latest widening was led by the wings, boosting their flattening relative to swaps, but leaving 12y behind**
- **This is likely based on anticipation of the uneven distribution of forthcoming APF purchases, but such pricing rarely lasts for long**

The UK's sell-off has started behaving differently to others

GBP rate moves over the first month of 2018 broadly followed the profiles of those in USD and EUR, with the belly leading the way, even if the timing of their moves were not perfectly synchronized. The GBP curve had a slight steepening bias relative to the others, as short-run BoE expectations proved slightly sticker than those around the Fed, but the long end followed the whole of the US's repricing.

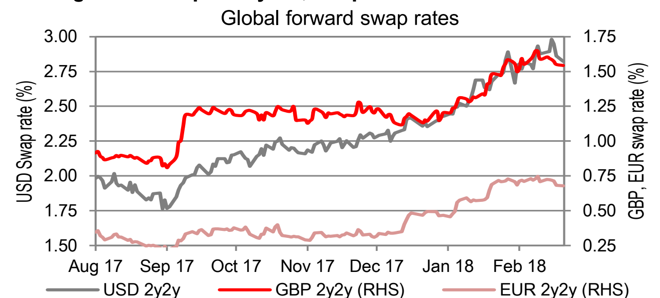
This close correlation broke down clearly during February, with the UK and Eurozone curves evolving in opposite directions and the US exceeding their bearishness at both ends (Chart 46). Long GBP rates had even managed to post a material outright rally. The MPC's hawkish, if backward-looking, language in the February Inflation Report set a bear-flattening trend, and the flattening continued relentlessly through the rest of the month even as 5y+ rates started to reverse their earlier outright sell-off.

Chart 46: UK rates' across-the-board flattening since January was at odds with the long-end steepening seen elsewhere



Source: Bloomberg, Santander. Changes from 31 January - 26 February

Chart 47: Short-dated forward rates in the UK and US have been moving in lockstep this year, despite different circumstances



Source: Bloomberg, Santander. Note the left and right axes have the same scale but with a 125bp offset.

Please see *That was then, this is now* for our initial thoughts on the Bank of England's Inflation Report, and our *Macro Markets Daily* from 22 February for observations on both the somewhat contradictory labour data and MPC/TSC testimony from the previous day. On top of the economic data, we see the heightened political conflict around the Brexit process as providing a major impediment to a Bank Rate hike – as explained in detail in the UK Economics, section, above.

We suggested fading the market's sharply hawkish interpretation of that Inflation Report, specifically versus the US, where we saw room more for Fed hikes to be priced in much more easily than for the BoE. The two markets have since tracked each other pretty closely at our suggested tenor, and a brief widening to 140bp did not last. US rates –and also, sooner or later, European ones– are likely to continue to provide the UK

with a bearish backdrop that should be hard for them to fully keep up with. But, in the near term at least, GBP rates do not seem inclined to deviate from the others, despite Brexit uncertainties and a less upbeat tone to UK macro data.

Developments in other markets historically prove more contagious towards longer tenors, so we expect the UK to re-join the bear-steepening trend, all else equal. One area where all may not be equal is the evolution of monetary policies.

- **Close trade idea: Receive 2y2y GBP vs. USD from 9 February.** This trade hit our target last week, but we suggested holding out for a potential dovish reminder from subsequent MPC speakers. But Ramsden now appears to have shifted in line with the majority. We would now take profit on this spread, now 11bp wider than at our original entry, and switch to trades within the GBP curve itself.

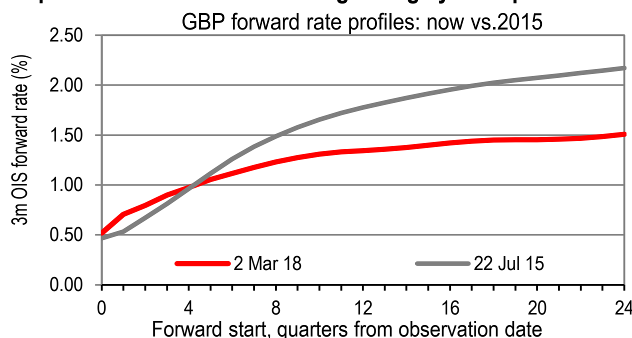
Front-loaded BoE hike pricing can leak further out the curve

- **Trade idea: GBP 1s5s OIS steepener.**
  Entry level = 39.5bp. Target level = 50bp. Stop loss = 36bp.
  3m carry = 3.5bp. 3m roll down = 3.9bp.

February's sell-off was remarkably concentrated in the shortest tenors of the UK curve, thanks to it being prompted by monetary policy shifts. A BoE hike is now ~90% priced for May, and a third hike in the current cycle by next February's meeting. Market expectations then taper off abruptly: for instance, the 4th and 12th short sterling contracts are now back to just 47bp apart, despite the 4th contract's yield now sitting 10bp higher than when the curve was last that flat, on 24 January.

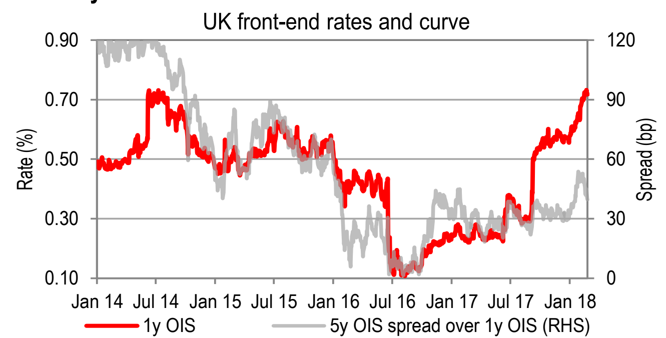
The spot 2y Sonia OIS rate tested 90bp during late February, a peak last seen in July 2015. But the profile of forward rates now is very different from back then, both within those front two years and particularly over longer tenors (Chart 48). The implied forward rates happen to be identical in one year's time, but then cross over sharply. The current curve tails off fast, and Sonia is barely projected to reach 1.50% –just four hikes– even six years from now, whereas the 2015 market implied a terminal rate above 2.00%. The very shortest rates have pushed up to their highest since 2014's post-Mansion House era, but slopes such as 1s5s have failed to escape their post-EU referendum ranges (Chart 49).

Chart 48: The path of forward GBP OIS rates is front-loaded and then very flat, barely reaching 1.50% in 5y, a sharp contrast to the protracted but slower-starting hiking cycle implied in 2015



Source: Bloomberg, Santander. 22 July 15 was the last peak in short rates.

Chart 49: As a result, very short UK rates are back to their post-Mansion House range from 2014, but the slope remains relatively flat



Source: Bloomberg, ICAP, Santander.

A BoE hike in May remains a stretch from the latest data. We still believe that UK macro data will fail to warrant a hike as soon as May, despite the MPC's apparent hawkish inclinations. By August, we forecast spot CPI to have slowed sufficiently to remove the impetus for action at all. Please see the UK Economics section of February's *Interest & Exchange* for more detail on the factors we see as driving inflation in coming months.

If we are correct, and the MPC ends up opting not to continue its embryonic hiking cycle this summer, short rates could be expected to return to the kind of profile seen in early 2016. That would imply 1y OIS falling by at least 30bp, but the 1s5s curve would have much less work to do (~10bp). It may not even need to fall at all if the market defers the anticipated hikes to 2019+, rather than writing them off, for instance if the MPC attempts to convey a 'hawkish hold' with its rhetoric.

One hike would likely open the gates to pricing for more. On the other hand, if the MPC was to proceed with an aggressive hike, we believe the market's unprecedentedly short-and-sharp expectations for the cycle would be liable to extend towards a more typical profile. That is, the slope would soon catch up towards its own range from 2015.

MPC members have often emphasised that they envision a cycle –and a "gradual" one, at that– rather than a sharp transition to a new rate regime. The communication accompanying any hike would be likely to stress that even more, in our view, to avoid becoming backed into a corner by excessively hawkish pricing for the immediately ensuring meetings, while bringing a more 'normalized' terminal rate onto the horizon. Even if the next hike remained priced for February 2019, speculation would soon turn towards further ones in 2019-20 rather than 'one (or two) and done'.

Either way, we believe that pricing this front-loaded will be hard to sustain.

International bearishness also favours UK steepening. Developments elsewhere can also support this trade, in our view. The USD OIS curve is currently also flatter than in 2015, but that makes more sense to us, with that market now five hikes into the cycle that was being anticipated in 2015, in contrast to the BoE being back to where it began. The correlation between UK and US rates is historically more robust at longer tenors, so the further bear-steepening tendency we still expect in USD would naturally exert more of a pull on 5y than sub-2y GBP rates.

The accelerating recovery in the Eurozone economy makes those rates a different story, again: the Eonia curve has been steepening much more firmly than USD or GBP, with the recent 50-60bp range of 2s5s its steepest for four years, outright, and since 2011 relative to Sonia. This variability shows that the cross-market correlation is loose, but does provide another marginal influence in favour of steeper GBP rates, in our view.

Libor-Sonia basis may remain wide, but could also steepen

The Libor-Sonia basis has moved materially since last time UK Bank Rate expectations were this high: the 1y GBP 6sOIS basis fell from 32bp to 9bp over the course of 2017, but jumped from there to (briefly) above 13bp last week. We prefer to compare OIS rates over time for analytical purposes: they are theoretically a cleaner and more consistent measure of underlying 'risk-free' rate expectations, whereas traditional Libor IRS are also influenced by liquidity and credit conditions which have been far from consistent over the last decade.

However, we always find it worth considering whether to express front-end rate trades using Libor or Sonia. The basis has shown limited directionality with outright (OIS) rates and, if anything, has tended to bear/tighten. So, we think other factors are needed to explain its widening and the likelihood of re-tightening.

As sudden as the recent GBP basis widening was, it looks positively tame compared to the 12bp by which the USD equivalent widened steadily over February! It also looks reasonably proportionate when compared to the recent rebound in measures of credit risk in UK markets (such as bank CDS and IG corporate bond-gilt spreads).

We believe there was also likely an element of anxiety ahead of the closure of the BoE's Term Funding Scheme (TFS) drawdown window, at the end of

February. We expect that contribution to the basis widening should soon fade, as we identify several reasons to see the closure as little to worry about:

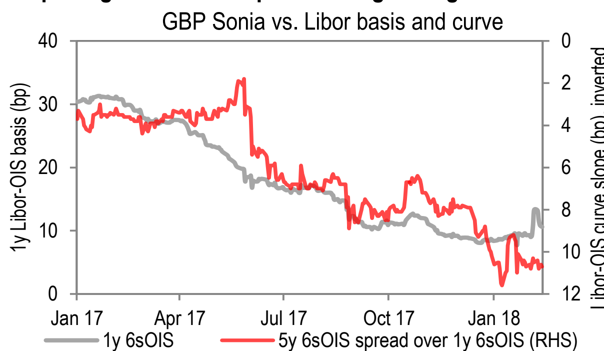
- Take-up of this Scheme was not as enthusiastic as it could have been (not all major banks even applied for access to it): only 88% of the potential maximum £144bn was borrowed.
- The £127bn of liquidity it delivered is still set to stay in the system for 3-4 years.
- (Global) excess reserves remain enormous.
- Other sterling liquidity facilities are still in place, such as the BoE's 6m Indexed Long-Term Repo (ILTR) operations.
- Those ILTRs have also seen low use recently, presumably side-lined in favour of the temporary but more flexible TFS, so can easily grow to fill any liquidity gaps as soon as the next tender on 6 March.

Even so, the mere prospect of any change and the loss of the reassuring existence of a potential term funding backstop may well be weighing on market term premia. Such nerves should soon fade once money markets are seen to function smoothly without new access to the TFS. Lastly, the worst tail risks should be discounted, in our view, as the BoE would most likely reopen it if any liquidity crisis was to occur.

The widening was quite parallel across the GBP basis curve, more so than would be expected from its steady steepening during the tightening trend (Chart 50). This suggests that, if the basis widening does persist to some extent, the basis curve may flatten back once things settle down. Separately, we also see the prospect of Libor's deprecation beyond 2021 as potentially adding tightening pressure around the 4-10y region (see our Gilt Spread Focus from 2 August for details).

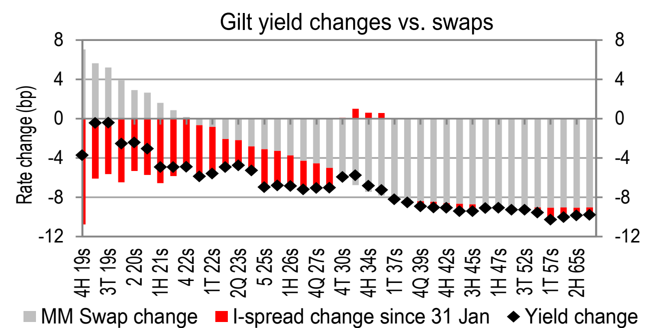
We do not have sufficient conviction on the direction or timing of such potential basis steepening to warrant a stand-alone trade. But, at the margin, a flexible investor could add it to our outright steepening view for potential extra upside: **receiving 2y OIS vs. paying 5y Libor.**

Chart 50: The GBP Libor-OIS basis widened abruptly last month, but the basis curve has not (yet) reversed any of the steepening which accompanied the grind tighter



Source: Bloomberg, ICAP, Santander.

Chart 51: The front-end flattening has been more muted in gilts than GBP swaps, as gilt spreads all tightened except for around 2030-36



Source: Bloomberg, Santander. Changes from 31 January – 2 March. Yield/yield spreads vs. 6m Libor swaps.

Long gilts have (mostly) flattened even more than swaps

The long ends of UK rates curves have also been flattening, and 10s30s in swaps is now back to levels last seen in 2009. We do not see the recent ~7bp slope as necessarily a meaningful floor, if the current hawkish monetary policy context can continue. If a UK hiking cycle is truly in progress, then a return to pre-crisis normality of flat or inverted long-term rates should not be ruled out.

To make another international comparison, USD 10s30s was always more upward-sloping than GBP in the pre-2009 era: inversion was by far the norm for the GBP curve, but the US's barely ever dropped below neutral. This makes its own range of 8-11bp over the last month a more historically remarkable low than the similar figures seen for the UK's, and make the UK's flattening look far from unsustainable.

We see the UK's long-end flattening as broadly reasonable, but find not favourable risk/reward in chasing it in the short run. Instead, we look for a good-value way to fade it: finding a laggard among the stronger flattening seen in gilts. Indeed, long gilt spreads in general have already backed of ~4bp from their late-February wides.

- **Trade idea: Gilt 30s/46s ASW box steepener.**
  Entry level = 22bp. Target level = 25bp. Stop loss = 20bp.
  3m carry = -0.1bp. 3m roll down = 0.8bp.
  Spreads quoted on a yield/yield basis vs. 6m Libor.

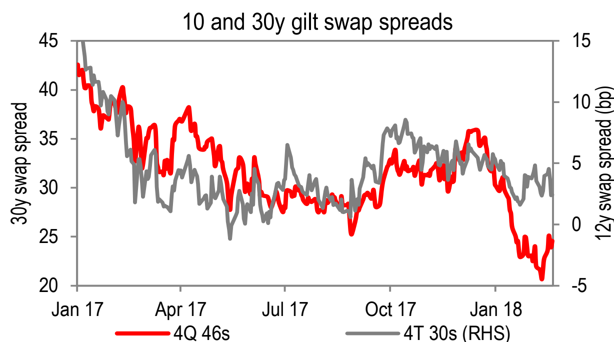
The extreme wings of the gilt spread curve have performed particularly well this month, offsetting much of the sell-off in short swaps and exacerbating the rally in the ultra-long end (Chart 51). We noted the unusually flat profile of the front-end ASW curve at the end of January, and recommended 2s3s or 2s4s spread steepeners (or, perhaps more practically, moving holdings of gilt ASW away from those vulnerable tenors in either/both directions). Those trades are 1-2bp onside, and we think they have further to go.

Spreads in the belly (5-15y) have been notably weaker, particularly for the 30s and 32s (Chart 52). We find the most likely explanation for this focused weakness to be restrictions on the APF's reinvestment programme, starting on 12 March: at £18.3bn, cash, its largest yet. The APF already holds its limit of 4Q 27s–32s, so they will be excluded from this month's operations.

The gilt market has often attempted to price in such differentiated buying, but the reality rarely lives up to the theory. A typical example was the richening of 20y gilts ahead of previous APF reinvestments, on the reasoning that this 'unpopular' sector with end-investors would particularly benefit from the APF's tenor-neutral strategy. But such richening usually faded almost as soon as the purchases actually began. We expect the opposite move in the 30s this time to prove just as short-lived.

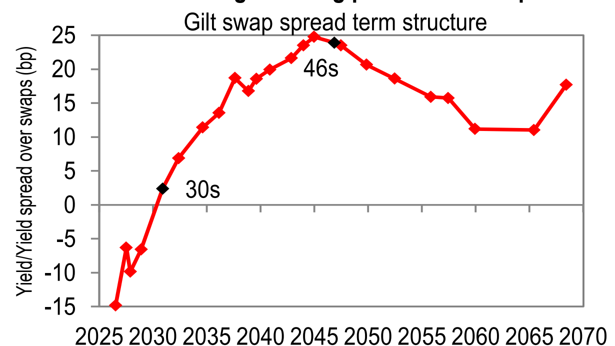
10-15y is a very steep sector of the ASW curve, offering the 30s scope for a strong roll-down effect even if the term structure does not move significantly. The 46s, in contrast, face 'roll-up' as they have long been slightly wider than the 44s and 45s (Chart 53).

Chart 52: 12y gilt spreads have barely benefitted from this year's longer-dated widening, staying well within their range from 2017



Source: Bloomberg, Santander.

Chart 53: The 2030s face a very steep 'roll-down' relative to swaps, especially after their recent tightening, whereas the 2046s are near the long-standing plateau on the spread curve



Source: Bloomberg, Santander. Y/Y spreads vs. 6m Libor.

USD – Rebound or slower decline?

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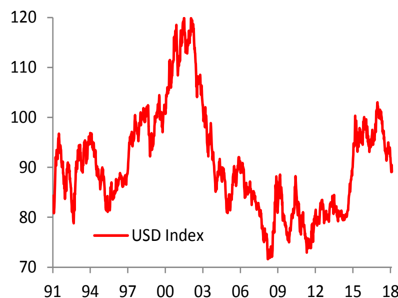
Taken from our latest FX Compass, published 22 February

The USD has remained weak, albeit picking up recently, but we still think that the market has adopted too negative a stance on the Greenback. We suspect that the USD selling frenzy should run out of steam, as the US economic outlook is upbeat, inflation is firm and the Fed should hike rates again in March.

The Dollar weakness that was seen in 2017 has continued into 2018. Last year, the USD was, by some distance, the worst-performing developed-market currency. That has more-or-less continued in 2018, year-to-date, although the CAD has performed a little worse than its next-door neighbour.

Chart 54: The USD decline is big, but not without precedent



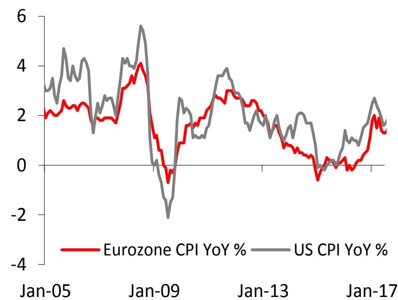
Source: Bloomberg, Santander

We maintain the view that some of the USD's decline, perhaps all of the H2-17 weakness, looks overdone. However, in technical terms, there is nothing too excessive about the Dollar's decline since the start of 2017. Since the start of January 2017 the USD index has dropped by around 14%. Aside from the multi-year USD bear market between 2011 and 2008, similar, and even larger, absolute declines to the current one were recorded between June'10 and May'11, May and November'09, Dec'93 and March'95, June'91 and August' 92.

Consequently, there are market/technical precedents for the USD to move even lower during the months ahead. However, we reiterate that several factors should slow –or even stop– further losses, if the market participants choose to focus more strongly upon them and edge away from the sell-USD momentum trade.

The expectation of imminent US rate hikes should be providing more support for the USD. At least three rate hikes are expected this year, with another three likely in 2019. US inflation was faster than expected in January, rising to 2.1% YoY from 0.9%. For comparison, Eurozone CPI stands at 1.3% YoY.

Chart 55: US CPI versus Eurozone CPI



Source: Bloomberg, Santander

The US fundamental backdrop should also be more Dollar supportive. The consensus expects the US economy to grow by 2.7% in 2018 and 2.3% in 2019. This 2018 rate is only expected to be beaten marginally by Australian and New Zealand.

The USD sell-off has accelerated recently after a decline in equity markets boosted demand for safe-haven currencies and weighed on the USD. However, equities have stabilised and the additional dollar decline came against currencies not usually viewed as safety plays, suggesting that the move was merely a continuation of general USD weakness.

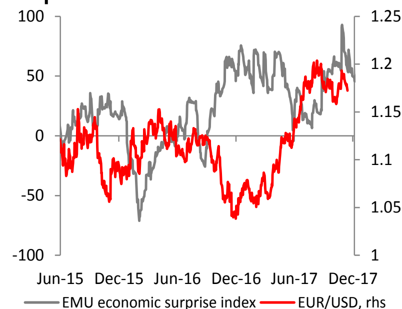
Whilst the market may be willing to test lower USD levels, non-US policymakers may become less tolerant as their economy is threatened by their own currencies strengthening versus the Greenback. Note the recent comments from Japanese politicians indicating greater concern about the Yen.

Admittedly, US political concerns could continue to weigh on the Dollar, together with a re-focusing on the US twin deficits (fiscal and current). In addition, the IMM data suggest that the speculative market is not overly short USD against all of its peers, although the short position versus the EUR is huge. This could imply scope for further USD losses, but for these losses to be more bespoke and selective, rather than the across-the-board selling that has been witnessed for most of the last year.

EUR – Do stop me now

The EUR remains firm, but we still believe it is on the expensive side. The Eurozone economy remains robust, but its impact on FX sentiment should now have been priced in. Ongoing USD weakness continues to help the EUR, but the expected Fed rate hike in March should support the Dollar. Meanwhile, a market that is already very long the EUR may be unwilling to bid it higher ahead of Italy's general election on 4 March.

Chart 56: The Eurozone economy remains firm, but where is the surprise in that?



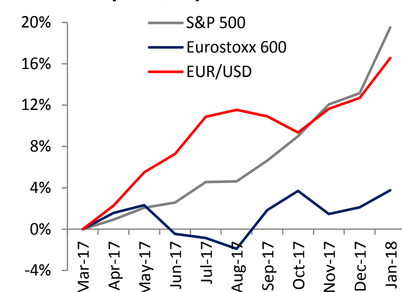
Source: Citi, Bloomberg, Santander.

Three factors have provided the bulk of support for the EUR since Q1-17: 1) a reduction in Eurozone-specific risk, normally political; 2) market recognition that the Eurozone economy had improved, and continues to do so; and 3) the USD sell-off. This trio may continue to bolster the EUR over the coming month, but their positive impact may wane.

The Eurozone economy remains EUR positive. However, the good economic news may have peaked. Business surveys remain very strong, but are starting to dip. Overall, the economic data continue to surprise to the upside, but less so than just a couple of months ago. Plus, we reiterate that economists still expect the Eurozone's growth to underperform the US's. The consensus expects US GDP growth of 2.7% this year and 2.3% in 2019, compared to 2.1% and 1.8%, respectively, for the Eurozone. Hence, the relative growth story should caution against being too long EUR/USD.

The FX market is far less concerned about European political risk than it was at the start of 2017. Recall that the market seem to be taking the prolonged effort to reach agreement on a new German government following the September 2017 election in its stride. However, the market may remain cautious ahead of Italy's election on 4 March and reluctant to pull an already strong EUR even higher.

Chart 57: Risk trade? % change in EUR/USD seems to follow US, rather than European, equities



Source: CFTC, Bloomberg, Santander

Indeed, it has been perceived US/global risk that has influenced the EUR more in 2018. The recent weakness in equity markets and concern over US fiscal policy have weighed on the USD and prompted a degree of safe-haven support for the EUR. The equity markets, for now, appear to have stabilised, which should curtail further EUR/USD gains.

Moreover, the high correlation between EUR/USD and US equity indices, together with the fact that the return on European stocks has tended to underperform their US counterparts over the last year, could imply that the impact on portfolio flows should not be viewed as automatically EUR/USD positive.

Overall, EUR/USD remains a zero-sum game, in our view. The EUR is likely to benefit if the USD remains weak. The correlation between the trade-weighted (TW) EUR and USD since the start of 2017 has been -0.94. Given that the Fed is expected to hike rates on 21 March and follow it up with at least two more rate hikes in 2018, we doubt that the EUR/USD gains can be sustained. But we concede that the prospect of ECB rate hikes in H1-19 implies a need to up our EUR/USD forecast at the start of next year.

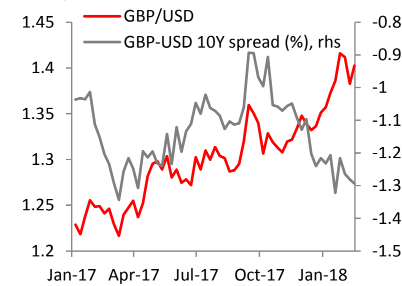
Plus, the long EUR/USD trade still looks to be very crowded, suggesting that a US rate hike may provide a catalyst to lock in profits. The IMM non-commercial position data for the week ended 16 February showed that the speculative net-long EUR/USD position had reached a new all-time high.

GBP – Where's the USD?

The Pound has posted a notable recovery against its developed-market peers over the last few months. We are sceptical about whether this will continue, and still see the Pound as vulnerable. Sterling's biggest gains

have been against the USD, with EUR/GBP remaining in a range, suggesting that GBP/USD's advance continues to owe much to the general Dollar weakness.

Chart 58: GBP/USD following the USD, not spreads…



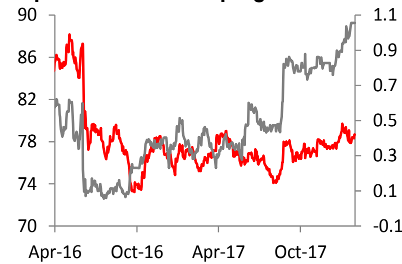
Source: Bloomberg, Santander

Consequently, as long as the FX market remains negative on the Dollar, GBP/USD is likely to strengthen. However, we find the UK fundamental/political backdrop far more ambiguous and risky for the Pound. So, the higher Cable goes now, the greater the risk of a big downside correction in the future may become.

Sterling has risen around 15% against the USD since 16 January 2017, while EUR/USD has strengthened by slightly more. This outperformance may be explained as a correction to previous over-selling against the Dollar. The Pound weakened a lot after the EU vote in June 2016, even though economic data came in better than expected, and the EUR, in our opinion, was oversold as the market focused on European political risks and the ECB.

The recovery in these pairs was also helped by general USD weakness. But, with Cable again flirting with pre-referendum levels of June 2016, the correction of that 'overselling', at least for GBP/USD, may now be complete. Hence, further GBP gains may now constitute overshooting, ignoring the economic and political risks that we believe are still present.

Chart 59: ...but MPC rate hike expectations are helping the Pound



Source: Bloomberg, Santander.

Whilst the UK economy performed better than expected following the referendum, it has still underperformed both the US and the EU. UK growth is expected to be around 1.4% in 2018, but 2.7% in the US. The recent market focus on the US twin deficits (current and fiscal), amid concerns over the speed at which the US will close its budget deficit, has been pounced upon as another US negative. However, the combined UK current account and budget deficits exceeds the US's.

Domestic politics and Brexit talks should remain a drag on GBP sentiment. An 'official' report 'released' recently indicated that the UK economy would be smaller under all the off-the-peg Brexit scenarios. For now and, arguably, quite a while, the FX market has taken a much more relaxed approach to Brexit, but this could change as the negotiations continue in the months ahead.

Admittedly, the interest rate outlook has helped the Pound. Rate hike expectations should continue to offer some GBP support. The MPC Minutes for the February meeting, suggested that UK rate hikes may come a little bit sooner than many had expected. The market is currently pricing in around a 63% chance of a UK rate hike in May, compared to 47% at the start of the month.

Indeed, it appears that the change in expectations about G10 monetary policy is increasingly viewed as a key driver for FX. Hence, even the expected three US rate hikes this year have not boosted the USD, because the market is focusing instead on the bigger increases that the UK and ECB will have to make to rates to 'catch up' with the US. However, the ECB is unlikely to hike until Q2-19, in our view, and we do not believe that a near-term UK rate hike is justified, limiting further GBP and EUR gains versus the USD and allowing EUR/GBP to remain in its current range.

Table 8: G10 FX forecasts

	Q1 18	Q2 18	Q3 18	Q4 18	Q1 19	Q2 19
EUR-USD	1.21	1.22	1.24	1.26	1.24	1.26
GBP-USD	1.39	1.36	1.34	1.32	1.32	1.33
GBP-EUR	1.15	1.11	1.08	1.05	1.06	1.06
EUR-GBP	0.87	0.90	0.93	0.95	0.94	0.95
USD-JPY	114	116	117	118	120	122
EUR-JPY	138	142	145	149	149	154
USD-CNY	6.40	6.6	6.65	6.70	6.80	6.70
EUR-CHF	1.16	1.17	1.18	1.20	1.22	1.23
USD-CHF	0.96	0.96	0.95	0.95	0.98	0.98
EUR-SEK	9.6	9.5	9.3	9.0	8.8	8.6
EUR-NOK	9.6	9.6	9.4	9.3	9.1	9.0
USD-CAD	1.25	1.24	1.24	1.22	1.22	1.20
AUD-USD	0.78	0.76	0.76	0.77	0.79	0.80
NZD-USD	0.72	0.70	0.71	0.72	0.74	0.76

Source: Bloomberg, Santander

Euro interest rate forecasts

Government Bond yield Forecasts

Bunds	Current	2Q18	3Q18	4Q18	1Q19	2Q19
ECB Refi	**0.00**	0.00	0.00	**0.00**	0.00	0.10
ECB Depo	**-0.40**	-0.40	-0.40	**-0.40**	-0.40	-0.40
3m	**-0.65**	-0.70	-0.65	**-0.60**	-0.55	-0.35
2y	**-0.56**	-0.45	-0.35	**-0.20**	-0.05	0.25
5y	**-0.01**	0.05	0.10	**0.20**	0.35	0.50
10y	**0.61**	0.70	0.80	**0.95**	1.15	1.30
30y	**1.27**	1.50	1.65	**1.75**	1.85	1.95

Swap rate forecasts

€ swaps	Current	2Q18	3Q18	4Q18	1Q19	2Q19
ECB Refi	**0.00**	0.00	0.00	**0.00**	0.00	0.10
ECB Depo	**-0.40**	-0.40	-0.40	**-0.40**	-0.40	-0.40
3m	**-0.33**	-0.33	-0.33	**-0.33**	-0.28	-0.14
2y	**-0.13**	-0.05	0.00	**0.15**	0.30	0.55
5y	**0.43**	0.45	0.50	**0.60**	0.70	0.85
10y	**1.05**	1.10	1.20	**1.35**	1.50	1.65
30y	**1.58**	1.75	1.90	**2.00**	2.10	2.20

US interest rate forecasts

Government Bond yield Forecasts

USTs	Current	2Q18	3Q18	4Q18	1Q19	2Q19
FOMC (mid)	**1.38**	1.875	1.875	**2.125**	2.375	2.625
3m	**1.61**	1.90	2.00	**2.25**	2.50	2.75
2y	**2.20**	2.45	2.60	**2.85**	3.15	3.35
5y	**2.56**	2.75	2.90	**3.15**	3.40	3.60
10y	**2.80**	2.90	3.05	**3.25**	3.45	3.65
30y	**3.08**	3.10	3.20	**3.50**	3.65	3.85

Swap rate forecasts

$ swaps	Current	2Q18	3Q18	4Q18	1Q19	2Q19
FOMC (mid)	**1.375**	1.875	1.875	**2.125**	2.375	2.625
3m	**2.02**	2.15	2.25	**2.50**	2.70	2.85
2y	**2.45**	2.55	2.65	**2.85**	3.10	3.30
5y	**2.66**	2.70	2.80	**3.05**	3.25	3.45
10y	**2.81**	2.85	2.95	**3.15**	3.30	3.50
30y	**2.90**	2.90	2.95	**3.25**	3.40	3.60

UK Interest rate forecasts

Government Bond yield Forecasts

Gilts	Current	2Q18	3Q18	4Q18	1Q19	2Q19
MPC	**0.50**	0.50	0.50	**0.50**	0.50	0.50
3m	**0.40**	0.40	0.37	**0.42**	0.45	0.50
2y	**0.75**	0.65	0.40	**0.50**	0.55	0.60
5y	**1.10**	1.10	0.90	**1.00**	1.20	1.30
10y	**1.44**	1.80	1.40	**1.60**	1.70	1.80
30y	**1.86**	2.10	1.90	**2.10**	2.20	2.40

Swap rate forecasts

£ swaps	Current	2Q18	3Q18	4Q18	1Q19	2Q19
MPC	**0.50**	0.50	0.50	**0.50**	0.50	0.50
3m	**0.58**	0.55	0.52	**0.52**	0.55	0.55
2y	**1.00**	1.00	0.80	**0.80**	0.95	1.00
5y	**1.31**	1.35	1.25	**1.30**	1.50	1.50
10y	**1.54**	1.85	1.50	**1.70**	1.80	1.80
30y	**1.62**	1.85	1.60	**1.70**	1.80	2.05

FX forecasts

	Current	2Q18	3Q18	4Q18	1Q19	2Q19
EUR-USD	**1.231**	1.22	1.24	**1.26**	1.24	1.26
EUR-GBP	**0.893**	0.90	0.93	**0.95**	0.94	0.95
GBP-USD	**1.200**	1.36	1.34	**1.32**	1.32	1.33
USD-JPY	**105.3**	116.0	117	**118**	120	122
EUR-JPY	**129.7**	141.5	145	**149**	148.8	153.7

	Current	2Q18	3Q18	4Q18	1Q19	2Q19
NZD-USD	**0.724**	0.70	0.71	**0.72**	0.74	0.76
USD-CAD	**1.286**	1.24	1.24	**1.22**	1.22	1.20
AUD-USD	**0.776**	0.76	0.76	**0.77**	0.79	0.80
EUR-CHF	**1.151**	1.17	1.18	**1.20**	1.22	1.23
EUR-SEK	**10.15**	9.50	9.3	**9.0**	8.8	8.6
EUR-NOK	**9.60**	9.60	9.4	**9.3**	9.1	9.0

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	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).

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	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.

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