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Interest & Exchange

Right direction, wrong speed?

Global Strategy: Despite our bearish view on US rates for this year, we have been surprised by the speed of the recent sell-off, which has already reached our June targets. We think the market might have over-reacted a bit and we keep, for the time being, our year-end forecasts unchanged. But we acknowledge that the bearish factors behind the sell-off are more fundamental and stable in time than those more demand-driven (and therefore level-dependent) factors that we expect to help yields to stabilize in coming weeks.

US Macro: According to the first estimates, US GDP grew by 2.6% QoQ in 4Q17 vs 3.2% QoQa in 3Q17. Growth came from strong personal consumption expenditures and accelerating residential and non-residential investments. The increase in capex anticipates a more positive trend in productivity. This, together with the lower contribution from inventories and strong external demand, points to stronger GDP growth in the coming quarters. We do not rule out upwards revisions to 4Q17 GDP.

US Rates: We continue to see value in paying the 2y2y, but feel that further gains in the 2s5s10s and 2s5s30s are limited as they have reached our proposed target. We now see tactical value in receiving the belly in 5s10s30s. As regards USTs, we maintain our bearish bias, particularly on an ASW basis, although we are switching our 2y trade to the 30y area.

EUR Macro: The encouraging results of household and corporate confidence surveys in the various Euro zone countries clearly reinforce a scenario of GDP gaining traction and increasing upward pressures on inflation. We would highlight the strong improvement in households' income expectations and companies' capacity constraints.

EUR Rates: The sell-off in EUR rates is partly due to very rich December levels but pressure at the short end shows that hawkish comments carry more weight than the ECB's 'official' stance. Rates look a bit over-sold, here. Steepeners are now priced more attractively than inflation longs. Fresh lows in SPGB spreads are rooted in fundamentals and we see space for further tightening. Italy looks cheap, due to the usual political risk premium ahead of elections.

GBP Macro: The path of consumer price inflation will inevitably prove a key influence on the outlook for UK monetary policy and GDP growth through 2018. We outline our key thoughts on the outlook for UK inflation in 2018, focusing in particular on domestically-generated inflation, and how a decline in imported inflation may provide an outsized boost to reported consumer spending growth.

GBP Rates: We largely attribute the recent sell-off to upward moves in interest rates elsewhere, although some small upside surprises in domestic data may have helped. Waiting for clarity on progress (or even intent) around Brexit has not prevented UK rates from joining in, but hiccups in that process could well push them back later in the year. Market expectations of a hiking cycle can continue to extend in the meantime, but we do not expect one to actually be delivered.

G-10 FX: We think the market is too negative on the USD. A strong US economy and rate hikes, should provide support. We have revised our EUR/USD profile slightly higher, to reflect higher spot. We expect EUR/USD at 1.21 in Q1, up from 1.15, 1.22 at end H1 (from 1.17). We are sceptical about whether the Pound's rebound will continue. But, the jump in the spot has forced a revision to our forecast. We expect GBP/USD at 1.39 in Q1 and 1.36 at end H1 (up from 1.28).

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

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	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 will revisit our estimates with the final tax reform details.	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.	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.	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 normalization in monetary policy, healthy macro environment and potential changes in the 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 but the recent sell-off is likely to experience a correction, near-term.	The UK should continue tracking rising rates elsewhere, despite the Brexit/political uncertainty headwind, but its recent catch-up may have gone a little too far.
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).	Policy rate expectations built into the short end are more fairly priced than the term premia. We therefore recommend steepening trades like 5f5y-5y and 30y-10y.	Front-end steepening likely has further to run, back towards ranges seen in 2015, but the long end should stay well anchored.
Spreads	Gradually unwinding SOMA reinvestments pose a risk for USTs. We like swap spread wideners (bearish USTs).	Periphery spreads should set new lows given the ongoing economic recovery and proportionately smaller net supply increase in periphery (vs. core) as PSPP slows.	The light supply outlook and excess liquidity make for a supportive environment, now largely priced in to long gilt spreads. 3-5y spreads look too wide/flat.
Volatility	The sizeable repricing in US rates is helping implied vols inch up. But they still look slightly cheap compared to delivered, particularly in the bottom left corner.	Central banks, especially the ECB, are clearly targeting lower volatility as a priority. Implied volatility is likely to remain low and with a relatively steep expiry term structure.	Implied vols remain low across the whole surface. The recent realized vol has helped lift them a little, but 10y+ tenor swaptions still look cheap.
Inflation / Break-evens	The spike in oil prices is helping BEs increase, but they still look fundamentally low, particularly in shorter tenors and vs. IL swaps.	10y ILS levels (1.6%) are now above accruing actual inflation (1.3% 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. Oil currently offers support, but wage growth is key for 2019 and beyond.
FX	The USD has come under a lot of pressure at the start of 2018. But the mix of a strong economy and further Fed rate hikes in 2018 should provide support.	EUR/USD gains look excessive, though economic data have been strong and supportive. The ECB's status quo stance and wider US-EU yields should weigh.	Sterling has been very strong, but much of the GBP/USD rally is due to dollar weakness. The Pound remains vulnerable to slower GDP, CPI and political uncertainty. But, for now, Brexit worries have faded.

Source: Santander Economics, Rates and FX Strategy Research. For a full list of contributors, please see contact details on page 35.

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

	USD	EUR	GBP
Govies	**Sell the 30y UST in ASW** Entry level = -12bp. Target level = -20bp. Stop loss = -8bp	**Buy SPGB 2.9% Oct-46; sell Bund 2.5% Aug-46** at 120bp. Target = 115bp.	**10s30s gilt ASW box flattener** (26s/47s). Current level = 44bp. Target = 37bp. SL = 47bp.
Rates	**1) Receive the belly in 5s10s30s** Entry level = 5bp.Target = 0bp. Stop loss = 7.5bp **2) Pay 2y2y in USD swaps** Entry level = 2.84%.Target = 3.00%. Stop loss = 2.75%	**1) Receive 10y IRS / pay 30y IRS** Now 48bp. Target=70bp **2) Pay USD 5y / Receiver EUR 5y** Now 214bp. Target=250bp **3) Receive 5y IRS / pay 5f5y IRS** Now 122bp. Target=130bp	**GBP 5s10s steepener**. Entry level = 22.5bp. Target level = 34bp. Stop loss = 20bp.
FX	**Buy USD/JPY** originally at 112.50,but now at current spot target= 120, with a stop loss at 108.15.	**Sell EUR/NOK** originally at 9.80, but now at current spot, target= 9.30, with a stop loss at 10.05.	**Sell GBP/USD** at 1.4145, target= 1.3900, with a stop loss at 1.4320

Global Strategy: Right direction, but wrong speed?

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- **Despite our bearish view on US rates for this year (our Dec'18 forecast for 10y USTs was 3.25%), we have been surprised by the speed of the recent sell-off, which has already reached our June targets. We think the market might have over-reacted a bit and, for the time being, we keep our year-end forecasts unchanged for now.**
- **But we acknowledge that the bearish factors behind the sell-off are more fundamental and stable in time than those more demand-driven (and therefore level-dependent) factors that we expect to help yields to stabilize in coming weeks.**

Global Recovery: Deep and wide and tall

The new year has started without any big macro surprises, especially in the Advanced Economies. Confidence surveys have hit new cycle highs in the US and most Euro countries*, and actual growth rates are also performing very well, although not as strongly as these surveys would indicate.

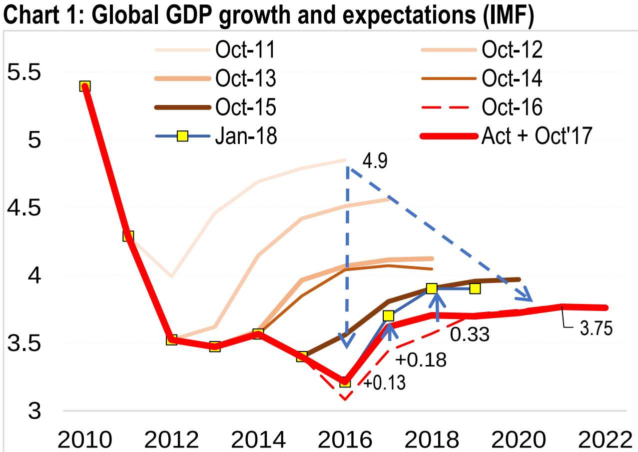
** The US ISM and Euro Zone Sentiment indices are around their multi-decade highs*

Indeed, for the second consecutive time, the IMF again raised its growth expectations for most economies, putting an end to a seven-year period of growth expectations being sequentially revised lower (Chart 1). Accordingly, the IMF forecast for 2018 global growth is now back to the level expected back in 2015 (3.9%) after a total +0.33% upward revision.

Two very important –and related– aspects for financial markets are: (1) this rosy outlook takes place in an environment where, mostly due to structural (rather than cyclical) factors, inflation remains subdued, allowing these countries' monetary authorities to remove their previous accommodation at a very gradual pace**; (2) partially thanks to the above factor, this expansion is becoming not only the **longest** in recent times, but also **the broadest** as, according to the IMF, only four –and not especially significant ones– of all the countries it follows are expected to contract this year (Chart 2).

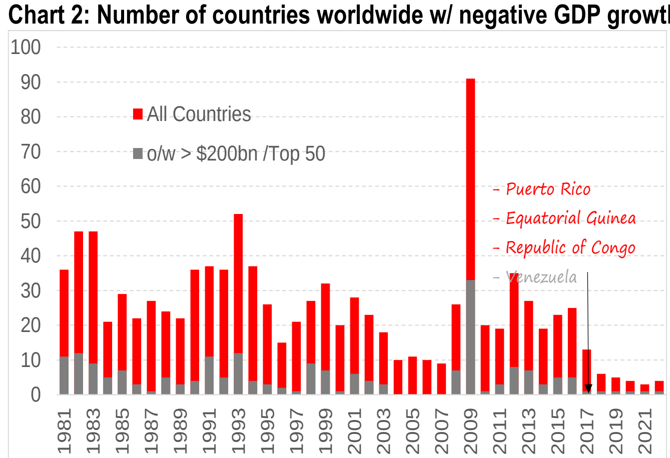
*** The avg 3m Libor rate expected for the G10 economies by Dec'18 is still <1%, rising to just 1.2% in Dec'19*

Chart 1: Global GDP growth and expectations (IMF)



Source: IMF, Santander

Chart 2: Number of countries worldwide w/ negative GDP growth



Source: IMF, Santander

In this strong-growth-but-accommodative-monetary-policy environment, it should not be a surprise to see risky assets performing very well. But the big question mark was how long would the QE-driven good performance in AE rates markets last, especially in those countries were monetary policy, both conventional and non-conventional, was in the process of being removed?

As discussed on our Year Ahead edition of the I&E, we expected a gradual increase in US rates throughout 2018, with EUR rates replicating c.70% of that movement and periphery yields relatively stable (ie, tighter spreads). But, we must admit the speed of the rise in US rates has surprised us and, therefore, we will have to assess whether this move simply brings forward our expected moves or whether it represents an extra increase, in which case we would need to revise our yield forecasts higher.

US rates are one of the key factors to watch in 2018, as a large and prolonged sell-off could affect most other assets

US rates: time to (already) update our 2018 targets?

Like most analysts, we expected US rates to trend higher during this year, having left their lows behind, mostly due to the improving fundamentals, growing funding needs and a less active Fed on the demand side, but more so on the monetary policy front. Nevertheless, we expected rates to remain below their fair value for a while given the still huge and cheap global liquidity in the system, helping possible yield-grabbing flows from global investors (especially out of Japan and the Euro area), as well as those more vertigo-prone investors in riskier assets (high yield, equities,..).

Below, we summarize some of the man drivers and implications for both short- and long-end USTs. Interestingly, some of the areas we are more concerned about (as regards a possible continuation of the US rates sell-off) are not necessarily those the market is paying more attention to, namely:

Table 1: Selected key drivers of US Treasury yields (and potential impact)

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

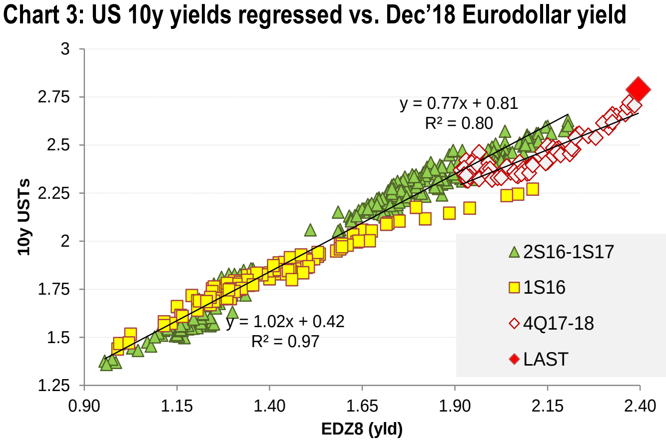
Long-term Rates	
SUPPLY	
· **Fiscal Deficit** ($563bn in 2018, $2.9trn in 2018-2021)	△△
· **Tax Reform** (+$136bn in 2018, $0.9trn in 2018-21)	△
· **Fed's b/s reduction** (+$252bn in 2018, $1trn in 2018-21)	△
DEMAND	
· **Domestic Banks** (+$740bn since 2014, could stabilize now)	=
· **International CBs/China =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?)	=/▽

* △△ / △ / = / ▽ / ▽▽ refers to the impact on US rates / UST yields

Source: Santander

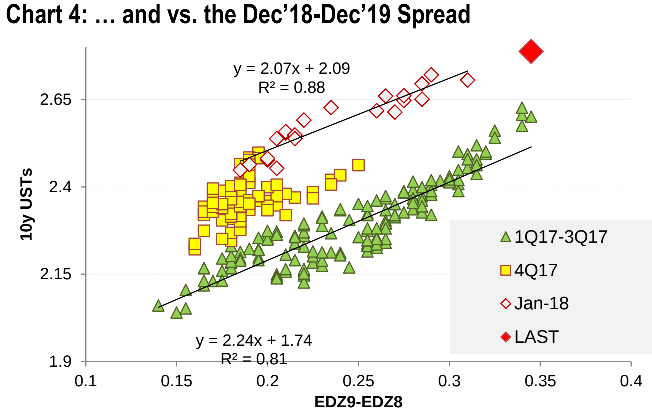
Monetary policy (▲) We continue to expect three 25bp Fed hikes in 2018. But, the market has basically converged with this view from the barely 35bp likelihood discounted a month ago. Despite the healthy macro, at this time we do not see the need for a faster pace of normalization given the risk –for global financial markets– inherent in a relatively 'new Fed' (new President and VP, and more hawkish members voting this year) being on a mission to hike 25bp per quarter, particularly given the impact of having to finance a chunky and growing amount of US public debt at increasingly higher rates.

Chart 3: US 10y yields regressed vs. Dec'18 Eurodollar yield



Source: Bloomberg, Santander

Chart 4: ... and vs. the Dec'18-Dec'19 Spread

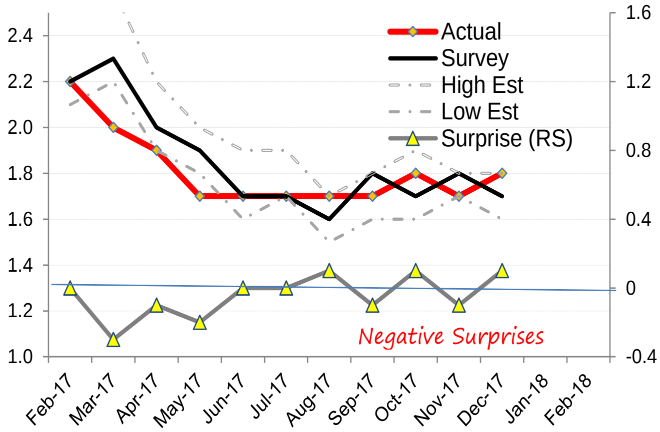


Source: Bloomberg, Santander

Given the c.75% beta between long- and short-term rates (Chart 3), we estimate the c.50bp sell-off in EDZ8 since November is 'responsible' for c35bp of the recent UST10y yield increase. If we are right about our 2018 Fed call, monetary policy should 'add' less than 5bp to the UST long end during the rest of the year 2018. But the risks we see are a 'non-stop' Fed in 2018, or market participants converging with the Fed's view also for 2019 (two hikes), as EDZ8Z9 currently trades at +35bp (Chart 4), although we doubt we will see a large repricing in this tenor in coming weeks.

Inflation and wages (▲) Despite all the structural headwinds mentioned last month, keeping Phillips curves flatter than in previous cycles (globalization, demographics, productivity, etc.), there are some incipient indicators that point to a slight acceleration of **wages** (some of them related to the tax reform making large companies review minimum wages). We also believe core inflation, which has remained in a tiny 1.7-1.8% range since May 2017 could accelerate somewhat towards the 2.0-2.2% area in coming months (Chart 5).

Chart 5: US core inflation and consensus expectations



Source: Bloomberg, Santander

Chart 6: Rising US rates (end b-e inflation) vs. a falling USD

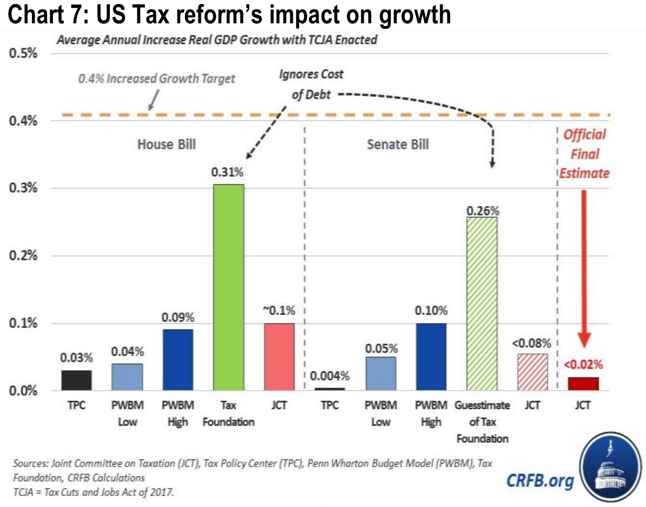
Source: Bloomberg, Santander

Exchange Rate (▲) Related to (and reinforcing) the above driver, a lot has been written about the recent EUR strength, but the truth is the USD is weakening significantly against practically all the major currencies. While still clearly above 2007-2013 levels, the trade-weighted USD has more than reversed the post-Trump rally and is currently 14% below its December 2016 highs (-3.5%YTD). Through import prices, but also helping competitiveness, the USD weakness will probably add some extra pressure for the Fed in coming months.

Supply (▲▲) We maintain that the aspect of the recent US tax reform we are most worried about (in view of its impact on US rates) is not so much the macro impact, which we believe will be limited, Chart 7 (at least the direct impact, as 'animal spirits' can be put to work).

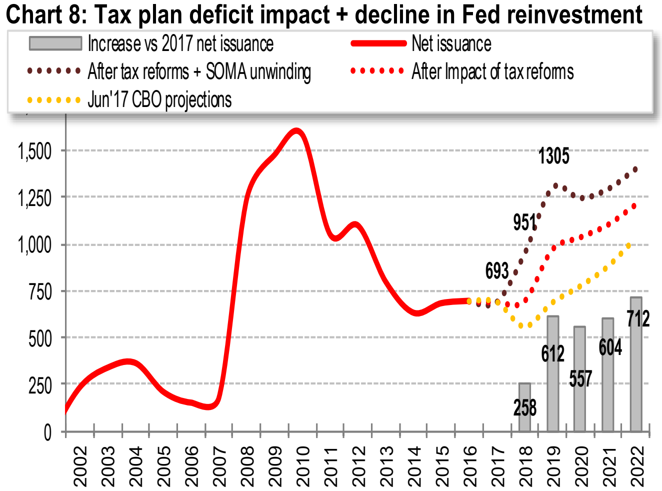
We are much more worried about how to finance this package, in an already large-and-growing fiscal deficit (and debt) environment, and with a much less help from the Federal Reserve, which is letting $250bn of its holdings mature this year (Chart 8).

Chart 7: US Tax reform's impact on growth



Source: CRFB

Chart 8: Tax plan deficit impact + decline in Fed reinvestment



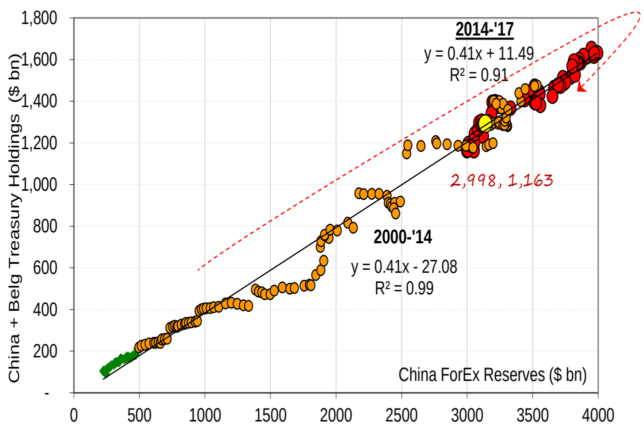
Source: CBO, Bloomberg, Santander

With all these supply and fundamental drivers pointing to rising short- and long-end US rates, the obvious risk is that the move seen in US rates over the last few weeks could continue at a similar pace. Logically, this would put the financial markets' current 'Goldilocks' valuations at risk.

As highlighted in our Year Ahead I&E, we do not expect yields to revisit their previous lows, but we still see **demand for US rates at certain levels**, thus slowing this rising-yield trend. We would focus on:

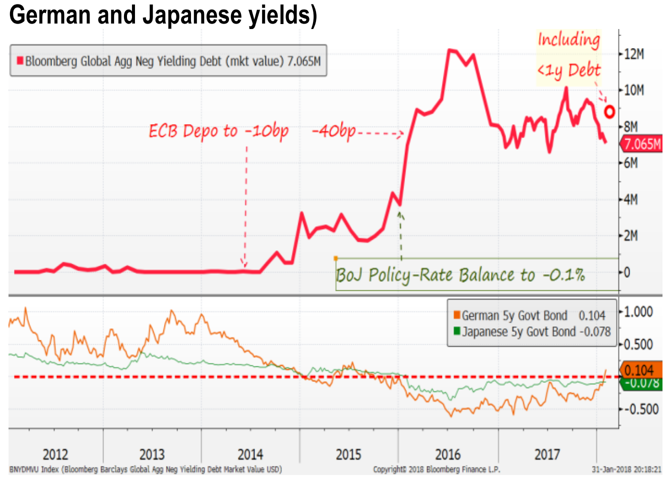
Chinese holdings of Treasuries (=/▼) A couple of weeks ago, the market focused on some comments from, allegedly, Chinese officials "reportedly thinking of halting US Treasury purchases". Bearing in mind we are talking about the largest holder of this asset (with over $1trn), the market obviously got nervous, but we believe the risk was overstated as, according to our analysis (Chart 9), China has been holding slightly above 40% of its official reserves in USTs, both when these reserves rose from $1trn to $4trn (2006-14), as well as in the subsequent decline to c.$3trn at the end of 2016. Taking into account that these reserves have been growing for the last few months (+$140bn) and that there are relatively few alternative assets for such a large portfolio, we do not think this should represent a major risk for US rates in coming months.

Chart 9: Holdings of US Treasuries by China* vs. Chinese foreign reserves (USD bn)



Source: Bloomberg, Santander

Chart 10: Total amount of global debt with negative rates (+ 5y German and Japanese yields)



Source: Bloomberg, Santander

Other international FI investors (=/▼) As mentioned previously, the increase in both the ECB's and the BoJ's balance sheets this year will outpace the decline in the Fed's. Moreover, despite the marked decrease recently, c.8$trn of government debt is still trading at negative yields (Chart 10). And note that, to get paid more in EUR sovereign paper (obviously in a different currency and with different funding rates and prospects) than the 10y UST's 2.72% yield, investors would need to buy 50-year SPGBs or 20-year BTPs (BBB). And 10-year JGBs continue to trade in the 5-10bp range.

For certain types of FI investors, especially those who think the USD is oversold, we believe USTs might represent an interesting long-term opportunity in the present environment of still huge and cheap global liquidity. Related to these two factors, last month we highlighted how the UST holdings held in the usual locations of large AMs and HFs (Ireland, UK, Cayman or Switzerland) were at all-time highs.

Holders of other financial assets (=/▼) A similar argument can be made for investors who hold other risky assets with, apparently, more stretched valuations, given extremely high-multiple equities (with already aggressive earnings forecasts) and historically tight credit spreads, and are willing to take some chips off. Interestingly, a significant increase in yields could be a potential driver for a repricing of these assets, as we have seen in the last couple of days, following a kind of Catch-22 argument.

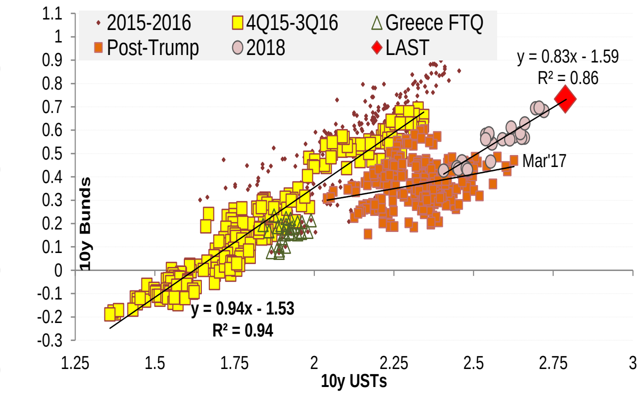
Fast money accounts (=/▼) According to CFTC, fast money accounts are <u>very close to their all-time highs in terms of their short positions in US rates</u> (Chart 11). This does not they cannot go shorter, but it does point to some difficulty in adding new shorts, especially when most of these positions have negative carry.

We believe <u>some of the accounts might consider taking profits on their shorts when / if rates stabilize</u>, potentially waiting for new entry levels.

Chart 11: Fast money accounts positioning in US rates (10y equivalents) vs. US yields

Source: Bloomberg, Santander

Chart 12: 10y Bunds regressed vs. 10y Treasuries



Source: Bloomberg, Santander

So, we stick with our US yield targets for now, but …

Acknowledging we were already bearish US rates, mostly given the above-mentioned fundamental –and supply– drivers, and noting that we were already above the consensus with a 3.25% forecast for 10-year Treasury yields by the end of 2018, we admit we have been surprised by the speed –rather than the direction– of the sell-off YTD, which has already reached our mid-year target.

That said, we think the market might have over-reacted (or reacted too early) to the latest economic figures and surveys, or even to the US tax reform news. We therefore opt to keep our Fed call and year-end US rates forecasts unchanged, and expect some stabilization in coming weeks.

Yet, we also acknowledge that, <u>while the bearish factors mentioned above are more fundamental, and stable over time, those that we expect to emerge and limit the sell-off are more 'subjective' and level dependent,</u> mainly being demand driven. And investors are obviously interested in grabbing these opportunities at the most attractive price level. So, we think they should wait for yield levels to stabilize in order to jump in, rather than fight an ongoing trend.

*We argued in our Year-Ahead I&E that we "**continued to favour carry-efficient shorts**".* Given the extent of the recent move, **<u>we might consider taking partial profits on a fraction of the position, looking for new possible entry levels.</u>**

EUR rates; lower beta, lower correlation

Regarding EUR rates, given the different supply-demand dynamics (the ECB will still buy all this year's net supply of euro govies), **we continue to believe EUR rates should replicate, with a declining-but-still-positive <u>correlation and beta</u>, the movements in US rates. Ditto for** Spain and Italy vs Bunds, ie, we expect peripheral spreads to tighten in a sell off, with demand for high quality FI assets emerging after any significant yield spike, to generate margin and earn extra yield.

US Economic Outlook

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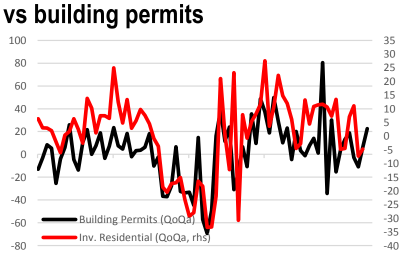
According to the first estimates, US GDP grew by 2.6% QoQ in 4Q17 vs 3.2% QoQa in 3Q17. Growth came from strong personal consumption expenditures and accelerating residential and non-residential investments. The increase in capex anticipates a more positive trend in productivity. This, together with the lower contribution from inventories and strong external demand, points to stronger GDP growth in the coming quarters. We do not rule out upwards revisions to 4Q17 GDP in the coming months based on higher inventory levels and a less negative external sector contribution than initially calculated.

Chart 13: US – Personal consumption QoQa

Source: BEA and Santander.

Chart 14: US – Residential investment vs building permits



Source: BEA, US Census Bureau and Santander.

Chart 15: US – Non-residential investments

Source: BEA, US Census Bureau and Santander.

The advanced reading of 4Q17 US GDP fell short of expectations (2.6% QoQa vs 3.0% QoQa expected and vs 3.2% QoQa in 3Q17). As expected, the growth came from investments and personal consumption expenditures. However, the net external sector's contribution was more negative than expected and the change in inventories was a lot smaller than forecast and that the levels reported in 3Q17. Judging from the latest readings of the European economic activity indicators and the monthly inventories data, we do not rule out some upwards revisions of 4Q17 US GDP.

Personal consumption expenditures accelerated sharply in 4Q17

The retail sales data published in 4Q17 point to personal consumption expenditures increasing by at least 3.0% QoQa in 4Q17 vs the 2.2% QoQa recorded in 3Q17. The advanced readings show growth reached 3.8% QoQa and was especially supported by the 14.2% QoQa increase, vs 8.6% QoQa in 3Q17, in the consumption of durable goods.

The strength of the labour market is also proving key for private consumption. Note that the 4-week average of initial jobless claims point towards non-farm payrolls growing between 2.0% and 3.0% YoY for 4Q17 (vs the current 1.41% YoY). This would be a slight acceleration in job creation that should help consumption continue to contribute positively to GDP growth in the coming quarters. This has an impact on consumers' confidence and supporting the purchases of big-ticket items.

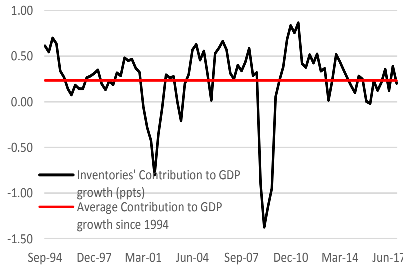
Note that we do not expect a sharp increase in average wages and salaries. In fact, and as we mentioned in our yearly report Thinking Macro 2018, automatization puts pressure on workers' remuneration in some sectors, while in others companies report a lack of qualified working force. So, on average, salaries remain subdued, although with clear inequalities among sectors.

Investments running full steam ahead

The first reading of 4Q17 GDP indicates that **gross fixed private investment** rose by +3.6% QoQa vs 7.3% QoQa in 3Q17, but this deceleration came from the **reduction in the level of inventories**, while fixed investments picked up to 7.9% QoQa vs 2.4% QoQa in 3Q17. We find these numbers very encouraging since both residential and non-residential investments increased (by 11.6% QoQ a vs -4.7% QoQa in 3Q17 and 6.8% QoQa vs 4.7% QoQa in 3Q17 respectively). Within non-residential investments, we highlight the acceleration of investments in equipment goods to 11.4% QoQa, after an already strong 10.8% QoQa reported in 3Q17. Investments in structures rose to 1.4% QoQa vs -7.0% QoQa in 3Q17. We find these numbers very positive since productivity has remained under pressure since 2010, even with hourly compensation decelerating. This means that the capital factor's contribution to productivity has been small, with the key here being the decline in investments in non-residential structures that started in 2009 with the crisis and only began recovering in 2016. The exception is the oil industry, where the development of fracking took the share of investments vs whole investments in non-residential structures from 15% in 2009 to 29% in 2014, which has now stabilised at around 20%. Since 2014, investments in non-residential structures have recovered slightly, although they remain at 2009 levels. We believe that companies increasing their investments will be the next step to foster productivity, further supporting growth in the coming quarters.

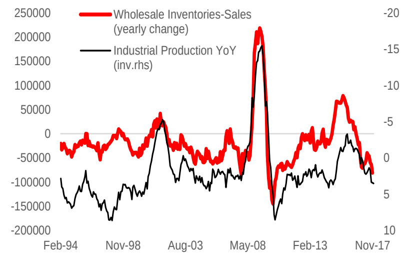
As shown by the building permits numbers and in the advanced 4Q17 GDP figures, residential investments picked up after a sluggish 3Q17 (to 11.6%

Chart 16: US – Inventories' contribution to GDP growth



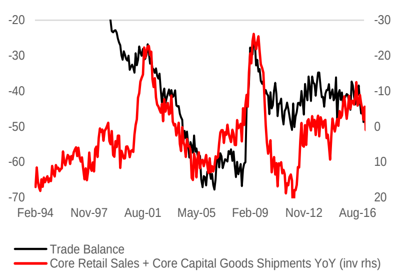
Source: Federal Reserve and Santander.

Chart 17: US – Inventories vs sales vs industrial production



Source: Federal Reserve and Santander.

Chart 18: US – Trade balance vs internal demand



Source: Federal Reserve and Santander.

QoQa from -4.7% QoQa). In fact, the hurricanes' negative impact on residential investments constituted a positive base effect for building activity in 4Q17. Moreover the accommodative financing conditions, together with employment generation, have helped take existing and new home sales to their highest level since 2007 and selling prices to historical highs. Note that, in the last Beige Book, realtors reported that sales were not rising quicker because of the low inventory levels. This means that residential investments are likely to accelerate further in the coming months.

Stronger-than-expected reduction in inventories that could be revised

In 4Q17 inventories contributed negatively to growth (-0.67pp vs +0.79pp in 3Q17) and we believe that these numbers could be revised slightly upwards in the second reading, although the level will likely remain below that in 3Q17.

The historical average indicates that inventories should contribute 0.26pp to US GDP growth, so we believe that this low level of stocks will lead to an increase in activity in the coming months. In fact, these low numbers, together with the strong internal and external demand, should pave the way for stronger activity levels in the coming quarters.

Note that not only are inventories low in historical terms, but the resulting level after sales is also at its lowest since 2008. This should fuel industrial activity in the coming months. In fact, we believe that this is another factor that will encourage companies to step up their investments.

A more negative external sector contribution than expected

According to the first estimates, imports rose very briskly in 4Q17, to 13.9% QoQa vs -0.7% QoQa, because of the growth in purchases of goods (+16.8% QoQa vs -0.2% QoQa) and services (1.7% QoQa vs -2.6% QoQa in 3Q17), while exports also rebounded firmly (+6.9% QoQa vs 2.1% QoQa in 3Q17), supported by goods exports(+12.6% QoQa vs 1.8% QoQa in 3Q17), while external sales of services declined by 3.3% QoQa vs 2.5% QoQa in 3Q17. Judging from the business activity reports and the consumption data in Europe and elsewhere, we believe that exports are likely to be revised upwards in the coming months.

The positive outlook for the world economy in 2018 should contribute to an additional increase in exports. Note, however, that the inertia of the strong labourt market and the still accommodative monetary policy in the US are likely to support further growth in domestic demand that could partially offset the positive impact from exports.

All in All: The breakdown of US advanced GDP for 4Q17 indicates that internal demand remains the main growth engine. Investment trends anticipate stronger productivity ratios and this should sustain growth further. We expect upwards revisions to the net external sector and inventories, leading to stronger GDP growth. We expect US GDP growth to average 2.5% YoY in 2018E and 2.6% YoY in 2019E.

US Rates Strategy: Updating our views after the recent sell-off

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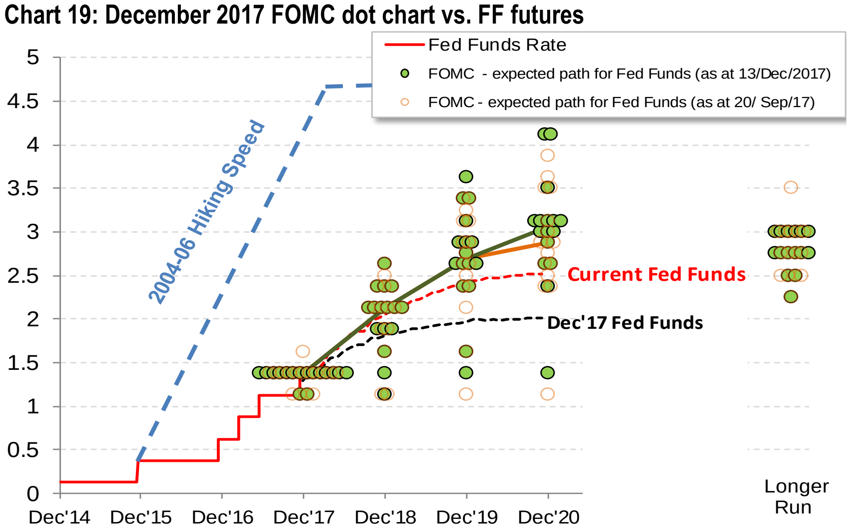
- **The year has started with a significant repricing in US rates that, while in the direction we were expecting, deserves some further analysis due to its unexpected speed.**
- **In general terms, the changes in the front end of the curve look consistent with the kind of correction we anticipated in monetary policy expectations. Despite the recent repricing, market expectations remain below levels suggested by the FOMC (particularly for 2019 and beyond). We add to our existing bearish view on the 2y2y in swaps, targeting the 3% mark (from current 2.84%).**
- **Moves in the belly and the long end, on the contrary, are not fully explained by fundamentals and in the current context of ample and cheap liquidity globally, we see a risk of some correction in the short run. We are closing our 2s5s10s and 2s5s30s trades well in the money, as further gains now look limited. While we continue to think US rates will trade higher all along the curve later in the year, we now believe the 10y might have overshot relative to the front and long ends of the curve and see value in tactically receiving the belly in a 5s10s30s fly.**
- **Lastly, the US government shutdown benefited USTs in ASW terms, particularly in the belly and long end. This move should prove temporary, as we believe the main risks for USTs (namely increased funding needs for the tax reform in a context of gradually smaller Fed purchases) have not been priced in yet. However, after the recent repricing, we see more value in the 30y tenor (rather than the 2y, as proposed in our Year-Ahead I&E).**

Front-end rates: market still underpricing the coming Fed hikes

Despite the sizeable repricing seen in the past few weeks, front-end rates have not yet fully priced in all the rate hikes suggested by the latest Fed's dot chart. As shown in Chart 19, market expectations for 2018 have already almost fully converged with the median of the FOMC dots (2.10% vs. 2.125%), but there is still room for additional increases in 2019 and beyond (the FFZ9 stands at 2.44% and the FFZ0 at 2.54%, while the median of the dots is 2.688% and 3.062%, respectively).

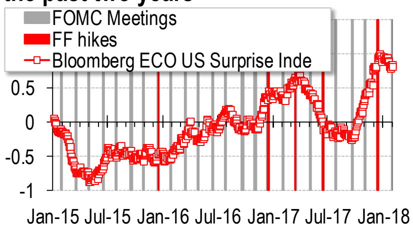
Chart 19: December 2017 FOMC dot chart vs. FF futures



Source: Federal Reserve, Santander.

Given that the US macro figures have been stronger than expected, in general terms, since the Fed published this chart in December (see Bloomberg's surprise index in Chart 20) and, more importantly, that the USD has weakened further during that very same period, we believe the Fed should feel quite comfortable going ahead with the pace of hikes currently implied by these dots. Hence, we think that front-end US rates have room for some additional increases.

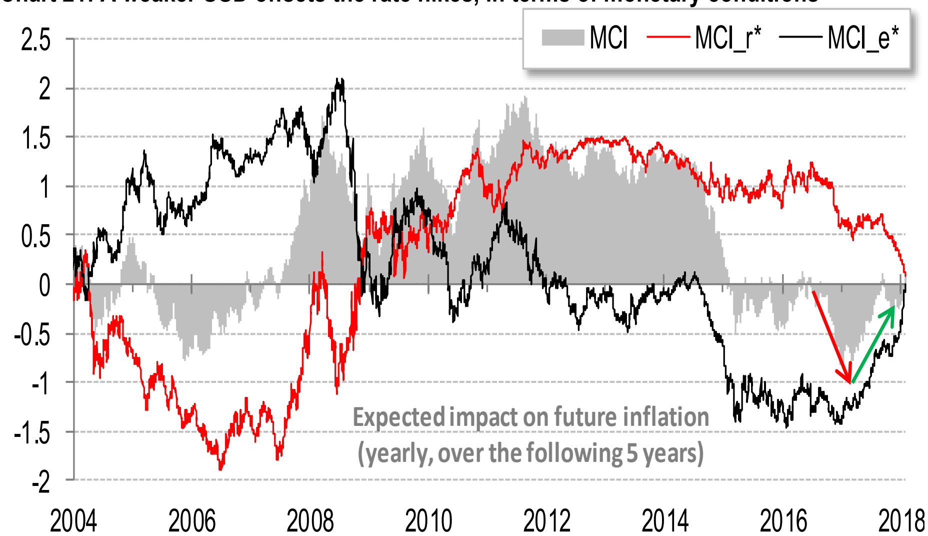
Chart 20: US economic surprises over the past two years



Source: Bloomberg, Santander.

Specifically, our Monetary Conditions Index for the US (Chart 21) suggests that the easing bias caused by the weakening of the DXY in the past few months (black line) has more than offset the tightening caused by the spike in front-end rates (red line). So, overall, monetary conditions have barely changed compared to 2015 (before the Fed started hiking rates).

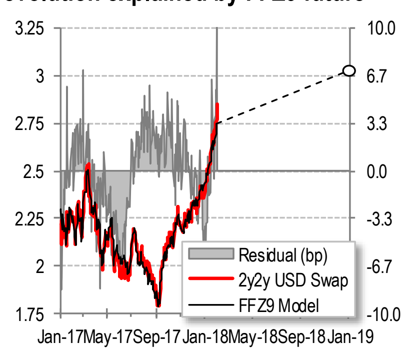
Chart 21: A weaker USD offsets the rate hikes, in terms of monetary conditions



For more details on this model please refer to our [29 September 2017 I&E](), page 10.
Source: Bloomberg, Santander.

As a result, we believe that the upward trend in front-end rates can continue and that the risk of a correction lower here is clearly limited in the current environment of healthy macro data and a weaker USD. This make us feel comfortable in continue paying the 2y2y as recommended in our Year-Ahead report, even if it has already run 30bp since we opened it and is trading through our initial target levels.

Chart 22: 2y2y USD swap – historical evolution explained by FFZ9 future



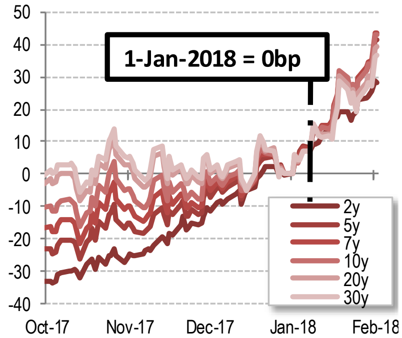
Source: Bloomberg, Santander.

Having said that, we would expect further increases to be less strong than in the past few weeks. As shown in Chart 22, if the market fully prices in the rate hike expectations indicated in the dot chart for 2019 (i.e., the FFZ9 rising from the current 2.44% to 2.69%), the 2y2y could keep climbing to the 3% area by the end of the year.

Trade idea: Pay 2y2y
Entry level = 2.84%. Target level = 3.00%.
Stop loss = 2.75%. 3m roll-down = -3bp

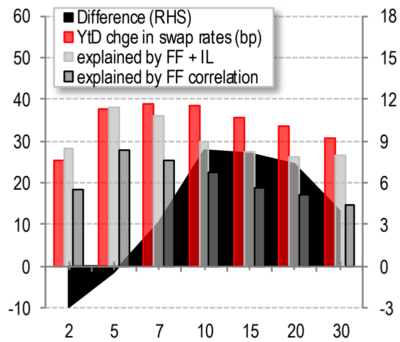
We opened this trade on 29 September, when the spread was at 2.10%, with a target at 2.40%. Then, in December, with the forward rate already at 2.30%, we decided to move to a new target, at the 2.70% area. Now that it is already trading at 2.84%, we maintain our bearish view on the front end and recommend adding to this position, with a new target of 3%. While we expect the movement to be slower than in previous months (this new target might not be reached until the end of the year), we expect the mark-to-market to beat the negative roll-down (-2bp during the first 3 months) in any case.

Chart 23: Cumulative changes in the swap curve (in bp, compared to the Jan 1 close)



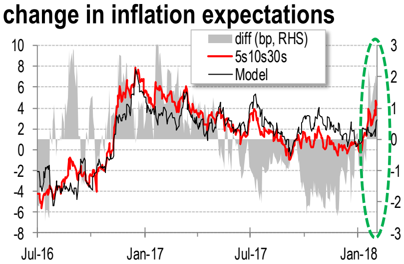
Source: Bloomberg, Santander.

Chart 24: Move in FF futures and inflation does not fully explain YtD changes in swaps



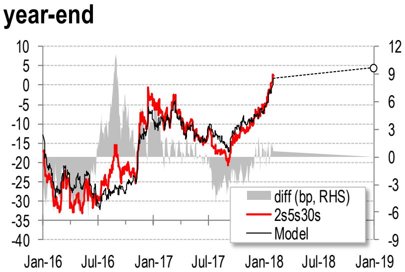
Source: Bloomberg, Santander.

Chart 25: The increase in the 5s10s30s spread might be overshooting the change in inflation expectations



Source: Bloomberg, Santander.

Chart 26: 2s5s30s are already close to the levels that would be consistent with 2y2y at 3%, our expectation for year-end



Source: Bloomberg, Santander.

Long-end move not fully explained by fundamentals, might see some correction…

As shown in Chart 23, USD swap rates have increased by 30-40bp all along the curve since the beginning of the year, in what seems to be longer rates joining the repricing already under way in the front end. While the repricing in the front end of the US curve was expected and, as just explained, we believe that the risk of a correction is lower than the risk of the trend continuing, we have some doubts about the sustainability of the move in the belly and long end.

As discussed in the previous section, the main fundamental changes in the past few weeks are, essentially, a weaker USD currency (that could result in some inflationary pressures and makes monetary conditions easier) and a repricing of monetary policy expectations (which is somewhat related, as this a change in the currency seems to be helping the market see the Fed's dot chart as more feasible). A deeper analysis of the changes in USD swap rates shows that part of the recent movement is difficult to justify with these changes in fundamentals.

If we measure the impact on inflation expectations as the change in IL swaps during this period, and we measure the impact that the change in monetary policy expectations might have had on the different tenors of the USD curve based on their historical correlation to FF futures, we find that the belly and, to a lesser extent, the long end of the US curves might have overshot during the recent movement. Chart 24 compares the actual year-to-date change in different tenors of the USD swap curve (red bars) with the change that would be consistent with the year-to-date moves in FF futures, according to the historical correlation between them (dark grey bars), and to the combination of changes in FF rates and IL swaps (light grey bars). The differential between actual market changes and those explained by fundamentals (black area) suggests that the 10-to-20y tenors have overshot by close to 10bp already.

Under this assumption, we find that there might now be more value in tactically receiving the belly in a 5s10s30s fly, trying to capture what we think should be a temporary dislocation (see Chart 25), while additional gains in the two butterfly trades proposed in our Year-Ahead report (2s5s10s and 2s5s30s), already at target levels, look much more limited (see Chart 26), and we prefer to take profits here.

Trade idea: Receive the belly in 5s10s30s
Entry level = 5bp. Target level = 0bp. Stop loss = 7.5bp.
3m carry = -0.2bp . 3m roll-down = -0.2bp

We open this trade at a spread of 5bp, targeting a return to the 0bp area. That area would be consistent with the market correcting the dislocations identified in Chart 24 and closer to the levels suggested by its correlation with current medium-term inflation expectations, as measured by its correlation with 5y5y IL swaps (Chart 25).

CLOSING TRADE: Pay the belly in 2s5s10s
Entry level = 1bp. Target level = 5bp.
Closing at 6.5bp

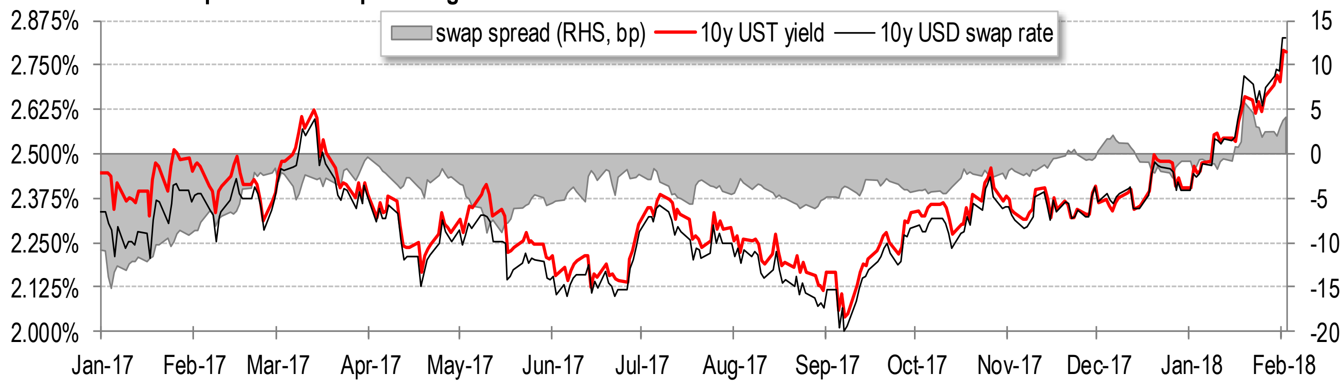
CLOSING TRADE: Pay the belly in 2s5s30s
Entry level = -8bp. Target level = 0bp.
Closing at 2bp

Both trades are well in the money and have reached the targets proposed in our Year-Ahead I&E. We believe that additional gains, while possible, are now much more limited.

… although the main risks for USTs have not being priced in yet

Another interesting point about the price action of the past few weeks is that USTs have clearly outperformed swaps in the belly and long end (not so much in the front end). It seems that the market has read the temporary US Government shutdown as a catalyst to push the 10y UST to trade inside the swap curve again (see Chart 27). This is contrary to our view on USTs, as we believe that a combination of less favourable supply dynamics (net issuance will inevitably increase to finance the US tax reform) and a Fed that is gradually stepping out of the market should weigh on USTs, making them underperform vs. swaps.

Chart 27: USTs outperformed swaps during the latest sell-off



Source: Bloomberg, Santander.

<u>Trade idea:</u> Sell the 30y UST in ASW
Entry level = -12bp. Target level = -20bp.
Stop loss = -8bp.

Table 2: Recent evolution of ASW spreads in the UST curve (bp)

	low on 26/12/2017	hig on 19/01/2018	current 02/02/2018	possible correction
2	19.7	20.1	19.1	-0.5
5	4.5	7.8	8.8	4.3
7	-2.8	2.6	2.3	5.0
10	-2.8	5.8	4.0	6.7
15	-2.1	7.2	5.1	7.2
20	-6.4	3.7	1.8	8.1
30	-22.9	-10.5	-11.8	11.1

Source: Bloomberg, Santander.

As explained in our Year-Ahead report, we believe the market will start to price these risks in sooner or later. Accordingly, we took exposure to that possible price action by selling the 2y UST in ASW. Fortunately, this tenor was not that affected by the relative performance between USTs and the USD swap curve, so the trade is indeed 1bp in the money now at -19bp, vs. -20bp back in December). The ultra-long end of the curve (the 30y) has, on the contrary, seen ASW spreads oscillate from -23bp to -10bp and, even though this has already been partially unwound, we highlight c.11bp of potential gains if the ASW curve returns to its end-December levels (see Table 2).

<u>CLOSING TRADE:</u> Sell the 2y UST in ASW
Entry level = -20bp. Target level = 0bp.
Closing at -19bp

Euro zone Economic Outlook

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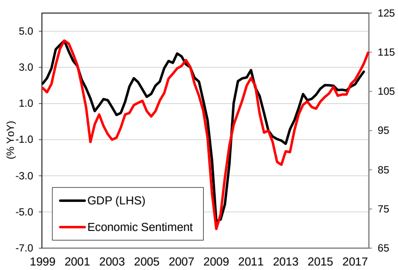
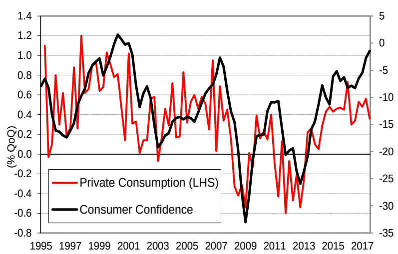
The encouraging results of household and corporate confidence surveys in the various Euro zone countries clearly reinforce a scenario of GDP gaining traction and increasing upward pressures on inflation. We would highlight the strong improvement in households' income expectations and companies' capacity constraints.

Chart 28: GDP and Economic Sentiment



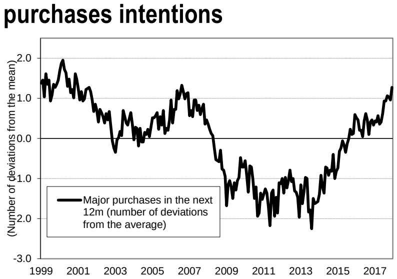
Source: Eurostat, EC and Santander.

Chart 29: Private Consumption and confidence



Source: Eurostat, EC and Santander.

Chart 30: Consumers' major purchases intentions



Source: EC and Santander.

During 2017, the Euro zone economy consolidated an upturn that, according to the encouraging results of the different confidence surveys among consumers and companies, seems to be gaining traction and with risks biased to the upside.

The current levels of optimism are, in many cases, at record highs, and are solidly supported by the improvement in fundamentals for domestic demand and the surge in exports. Furthermore, in our view, a major synchronization in the recovery among sectors and countries is a clear sign of increasing upward risks for inflation.

Strong improvement in households' income expectations

Consumer confidence is accelerating and has reached its highest reading since 2000. Households' assessments of the economic and financial situation are very close to their historical highs since 1999, clearly supported by the progress in reducing unemployment as a result of the pace of job creation maintained by the economy. This improvement in income expectations, in a context of contained inflation, has resulted in a growing propensity to spend and an increase in their intentions to make major purchases in the next 12 months.

Importantly, all the major economies in the area show better readings of households' sentiment and augur a very positive performance by private consumption in coming quarters, according to our estimates, consistent with a quarterly growth rate of close to 0.9%. Although, admittedly, sentiment could overestimate the real pace of spending growth, these readings point towards, in any case, a crucial contribution from the Private Consumption (56% of total GDP) to economic expansion in coming quarters.

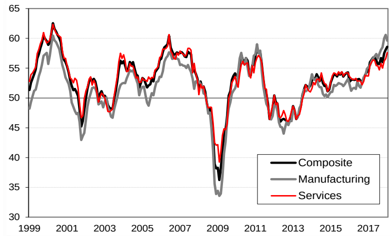
Companies face capacity constraints coping with demand

According to the preliminary business confidence numbers for January, the Euro zone has begun 2018 with activity accelerating at its fastest in nearly 12 years. In general, companies are very optimistic about the outlook for the year ahead, thanks to the increase in demand for both goods and services that, in many cases, exceeds supply and highlights clear capacity constraints in some segments. That said, we note, on the one hand, the speed of the improvement in companies' optimism and, on the other hand, the solidity of the upturn in terms of both sectors and countries.

In the manufacturing sector, and added to the aforementioned positive performance by households' consumption, the surge in exports has provided an additional boost to manufacturing activities. In fact, capacity utilization is already at 83.8% for the whole area, that is, one standard deviation above its historical average. The pace of production is lower than the increase in orders, so companies are reducing the level of inventories quite fast and, despite that, the backlog of orders continues rising. Obviously, these trends augur a very good performance by investment and employment in the sector.

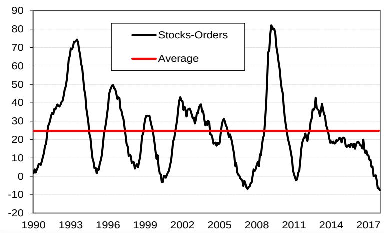
Furthermore, the surge in services is clear, in this case, mainly driven by strengthening domestic demand, something that is particularly relevant for GDP growth perspectives given the high weight the sector represents in these advanced economies. Again, according to the surveys, services activity could be rising at the fastest rate for over a decade and employment growth is close to a 12-year high.

Chart 31: Confidence among sectors



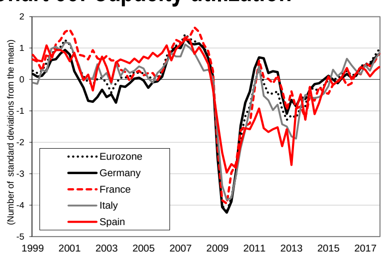
Source: Markit and Santander.

Chart 32: Orders vs. inventories



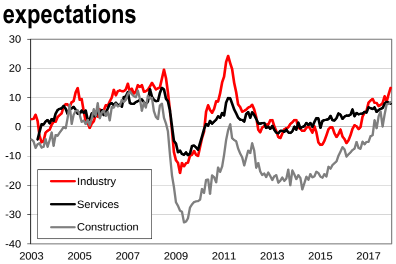
Source: EC and Santander.

Chart 33: Capacity utilization



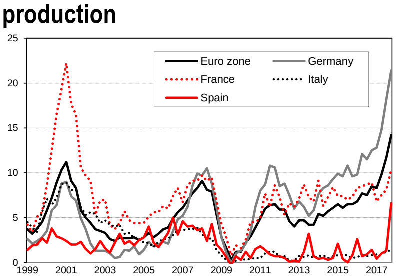
Source: EC and Santander.

Chart 34: Companies' price expectations



Source: EC and Santander.

Chart 35: Labour as a limit to production



Source: EC and Santander.

Lastly, and after several years of decline, construction activities also exhibit a clear recovery in confidence, at its highest since 2008, fuelled by the surge in orders. At the end of the day, these readings support a continuation of the positive contribution by the sector to both GDP growth and employment for the whole area.

All in all, the increase in demand (both internal spending and exports) is fuelling orders at a speed that companies are struggling to cope with. Needless to say, in this context, employment is growing across sectors and expectations about the coming quarters remain very positive, something that reinforces the favourable perspectives for the performance of private consumption. In our view, the next step should be a more evident upturn in net investment in the area, once companies are confident about the continuation of the positive tone for demand. According to our estimates, the Euro zone is in a scenario of a clear and sustainable reactivation, growing at above 2.0% YoY, and with the balance of risks biased to the upside, even taking into factors such as political uncertainty and the appreciation of the euro exchange rate.

More evident upward pressures for inflation

Sooner or later, the positive news on growth in the area should also be accompanied by a change in inflation expectations. But, even in a context where, according to our estimates, GDP could log 2.3% growth in 2017E, headline inflation rising to 1.5% in 2017 (from 0.2% in 2016) was clearly explained by the rebound in the energy component, while core inflation remained at 0.9% (vs 0.8% in 2016).

Admittedly, households maintain contained inflation expectations and this factor is likely to have contributed to their very positive views on their future real income.

Furthermore, the intensification of prices pressures on the supply side is evident, although just on the cost side, with most of the companies finding difficulties to rise their final prices because of high competition. But this seems to be changing: confidence surveys reveal an increasing number of firms reporting a rise in raw material costs and, importantly, its pass-on to clients. In fact, the increase in charges is said to be the sharpest since April 2011. In other words, the improvement in companies' pricing power in both manufacturing and services should weigh on inflation expectations.

At this stage, it is also quite significant that, due to companies' aforementioned capacity constraints, employment is a factor which seems to be limiting an expansion in production. This phenomenon has been very obvious in Germany since 2014, but it seems that that is also beginning to be the case in Spain. At the end of the day, this implies that a shortage in employment in some sectors and countries is already emerging and, with it, potential upward pressures for wages.

All in all, the Euro zone is at a very positive moment in the cycle that, far from being short-lived, we believe is supported by the improvement in fundamentals for demand. For 2018E, the confidence survey results clearly indicate a scenario of higher growth rates in nominal GDP.

Euro Rates Strategy: Is the sell-off running ahead of ECB reality?

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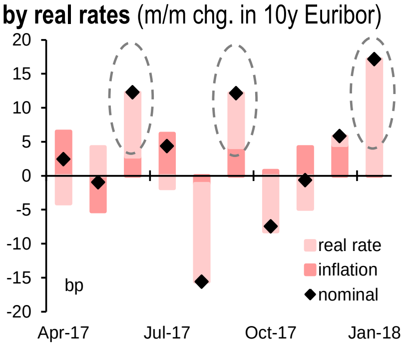
- **Part of the recent sell-off in EUR rates can be blamed on the very rich December levels, but pressure at the short end implies that hawkish comments carry more weight than the ECB's 'official' stance. Rates look a bit over-sold, here.**
- **The big-picture risk is still to the upside, given the macro strength and policy outlook globally, but steepeners are now priced more attractively than inflation longs.**
- **Fresh lows in SPGB spreads are rooted in solid fundamentals. We see space for further tightening and attractive Sharpe ratios. Italy looks generally cheap, due to the usual political risk premium ahead of elections.**

Market sentiment looks more hawkish than ECB majority

Chart 36: Another 10y sell-off driven by real rates (m/m chg. in 10y Euribor)



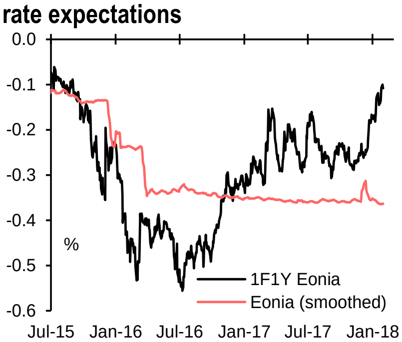
Source: Bloomberg, Santander

By the middle of last December, the real yield on the 2026 Bund€i had dropped to as low as -1.2% (10y Euribor – 10y inflation swaps was around -0.8%). From such low levels, a bearish correction is not surprising and, **by late January**, those **10y real rates stood 25-35bp higher**. We identify two main factors to explain the latest sell-off: a more hawkish market interpretation of ECB policy prospects and a more general rise in G7 rates, catching up with global economic optimism.

Looking first at **monetary policy expectations**, near-starting forwards like the 1-year rate, 1-year forward starting (1f1y) put in a sharp rise. Assuming fairly stable spreads between EONIA fixings and the ECB's Deposit Rate, the date by which the market could be said to price in the first 10bp rise in the Deposit Rate has shifted from late Q2-19 to Q1-19. The first 'full' 25bp hike went from being priced in by the end of 2019 to the middle of that year.

What justifies such a correction? The number and frequency of Governing Council member comments that could be construed as less dovish than Draghi's mantras about patience and prudence (in policy normalisation) have increased. To some extent this was also shown by the 'account' of the December meeting. Furthermore, global and Eurozone output growth continues to accelerate.

Chart 37: Sharp uptick in near-term rate expectations



Source: Bloomberg, Santander

It is equally true, however, that **core inflation is stagnating near 1%** and that the **trade-weighted EUR exchange rate has rallied** enough to wipe out nearly all the effects of higher USD oil and import prices. The lack of clear, sustained inflation convergence towards the ECB target was highlighted, again, by Draghi at the recent 25 January policy meeting. The fact that ECB policy communication between March and April will probably begin to move away from the long-standing QE and rates-timing wording is probably being over-interpreted by the market.

We expect that **any clarification of the timing of the end of APP and subsequent rates sequencing to reinforce the view that rate hikes will not start before Q2-19 and will be extremely gradual**. With the 3m Euribor futures priced near 0.5% for Dec-19 and near 1% for Dec-20, **the very short end has very limited room for higher rates, in our opinion**.

At the broader, global level, US Treasuries have led yields higher, with the 10y on-the-run up by nearly 40bp, from mid-December to the recent January highs. There, too, the bond market has reasons to sell off (tax cuts, rampant equities), but may well have over-extended its move. See the USD rates section for more detail. To recap our underlying and tactical duration view:

- **Over the course of the year, EUR rates will set fresh highs** on the basis of Fed rate hikes, the end of the ECB's APP and global expansion.

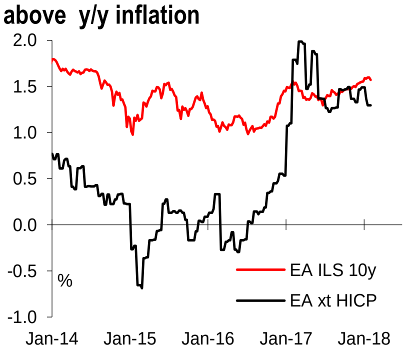
- **From current levels, we expect consolidation, or even a bullish correction**, given the aforementioned factors. Every sell-off in the cycle that began in 2016 was 'faded' by the market and we think this one will be no exception.

Steady rise in traded inflation despite stable core figures

Although the sell-off was recently led by higher real rates, **market-traded inflation has also crept steadily higher since the middle of last year**. We held an active recommendation to exploit the attractive carry characteristics of being long break-even inflation (BEI) in comparatively cheap SPGB€i from March to December of last year.

BEI rose considerably in the latter part of that period, adding to the significant positive accrual of realised inflation, which led us to recommend profit-taking. Since then, in inflation-linked swap (ILS) terms, 10y inflation pricing has broken above the previous relative high set in January 2017. What is the near-term outlook for market-traded inflation?

Chart 38: Euro area 10y ILS back above y/y inflation



Source: Bloomberg, Santander

- Oil prices remain on an upward trend but, thanks to the EUR currency appreciation, the impact on Euro area HICP should be relatively contained.
- Euro area unemployment has been falling by about 1% per year, in this cycle, and, at 8.7%, it is now below the 1992-2007 average. Furthermore, the employment rate is at an all-time high.
- Global consumer price inflation, in 'core' terms, has shown very moderate upside, and the same is true in the Euro area.
- Despite high employment, labour costs are still rising at a sub-2% pitch which, combined with moderate but steady productivity growth, means that unit labour cost inflation was still running below 1% by Q3-17.

All told, core HICP at 1% continues to lag behind leading indicators that used to be reliable pointers of higher prices. One would expect the core measure to be closer to 1½ % at this point in the recovery. Without pretending there is a simple causality chain in inflation dynamics, we can still think that **core and ex-energy HICP is unlikely to fall further and is more likely to creep toward 1%-1¼% over the next couple of quarters**. Barring a substantial reversal in oil prices, that should mean headline at just above 1½%, once base effects fall out. Given all that, we expect a gradual rise in BEI / ILS but not any sort of *surge*. With ILS and quite a few BEI levels close to, or even above, current inflation accrual, the long-inflation trade is not as attractive from a carry standpoint. It is no longer a 'cheap short'.

In terms of duration / macro positions, we stick to the carry-friendly recommendations we made in year-ahead issue of our Interest & Exchange: USD-EUR 5y spread widening and the 10s30s steepener. The latter experienced some flattening recently and we've updated the levels. In addition to those positions, we recently added what we see as statistically attractive 5f5y – 5y steepener.

Trade idea:

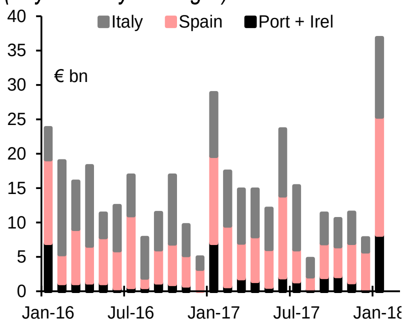
Pay 5f5y Euribor swap
Receive 5y Euribor swap

The original spread was 119 bp (currently 121 bp), with a target of 130 bp and a stop at 110 bp.

Spain leads periphery spreads lower

We ended 2017 with the view that fundamentals and flows would favour further outperformance by SPGBs, as well as other periphery Eurozone government bonds (EGBs), and recommended positioning accordingly. The year-end period saw some temporary spread widening, due to window-dressing in our opinion, which was quickly unwound in January. At the time of writing, the SPGB-Bund 10y spread, just under +80 bp, stood at levels last printed in 2010, as did that for PGBs. BTPs have lagged, relative to Iberian paper, but have also outperformed, recently.

Chart 39: Periphery tightening has not been harmed by heavy supply *(10y maturity or longer)*



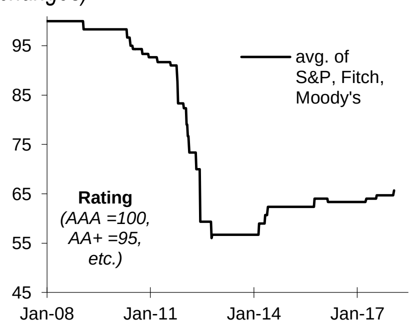
Source: Debt management agencies, Santander

As fundamentals continue to improve SPGB spreads can tighten further

Based on investor comments, there is a considerable body of opinion that thinks recent gains, while justified, offer limited further performance. However, the very strong price action took place in an environment of particularly heavy start-of-year supply (like the €10bn syndication of the new 2028 SPGB) and suggests that fresh money is flowing into SPGBs. On a fundamental basis, we think SPGBs should continue to benefit from:

- **Ratings momentum.** On 19 January, the first Spain upgrade since 2015 was delivered by Fitch (from BBB+ to A-). At the next scheduled review on 23 March, we believe S&P (currently at BBB+, 'positive') is likely to deliver another upgrade.
- **Attractive Sharpe ratio.** The yield pick-up remains substantial and lower outright yield volatility means that periphery paper produces better Sharpe Ratios than core EGBs.
- **Debt/GDP ratio compression.** Spain is reducing its debt/GDP ratio to below 100%; comparable to French or Belgian levels. Employment, economic sentiment, investment and exports have all continued to trend higher.

Chart 40: Spanish sovereign ratings in numerical format *(including outlook changes)*



Source: Rating agencies, Santander

In our Year-Ahead document, we set out two representative positions relating to periphery spreads:

- "Overweight periphery bonds" (buy SPGB 1.45% Oct-2027; sell Bund 0.5% Aug-2027); and
- "Buy medium-term periphery bonds forward" (buy SPGB 4.4% Oct-2023; sell Bund 2% Aug-2023)

We recently switched the first position from the 10y maturity bucket to the 30y one, with a tighter stop to reflect fast market conditions.

Trade idea:

Buy SPGB 2.9% Oct-2046
Sell Bund 2.5% Aug-2046

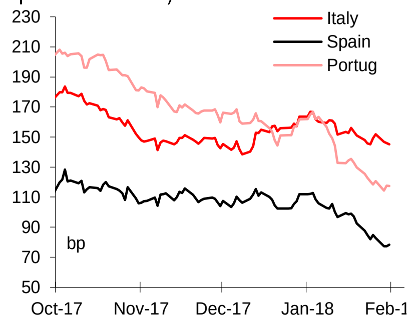
The current spread is 125 bp (originally 130 bp). Target is 115 bp. The stop was at 137 bp. Carry is roughly +½ bp per month.

BTPs look cheap to core, due to approaching elections

As mentioned, BTPs have outperformed relative to core but at a much slower pace than Spain or Portugal. The current 10y BTP-Bund spread remains roughly 55 bp above early-2015 lows and, relative to SPGBs, Italian paper is back to the higher end of its post-2012 range.

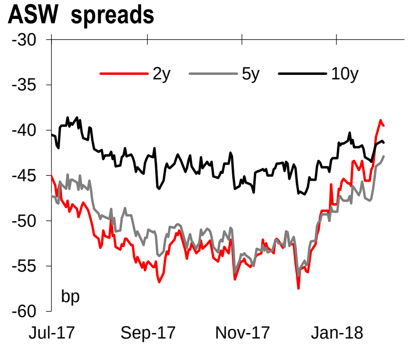
This Italian delay is partly based on medium-term fundamentals, such as the fact that Italian GDP growth is still 1/1½ points slower than in Spain/Portugal. Furthermore, Italian banks started reducing sovereign risk and NPL exposure

Chart 41: BTP spreads have lagged in the recent spread tightening (10y spread to Bunds)



Source: Bloomberg, Santander

Chart 42: Sharp tightening in core ASW spreads



Source: Bloomberg, Santander

later than other periphery economies. While all that justifies some yield premium by BTPs over Spain, for instance, data from the second half of 2017 show that convergence has begun on all fronts. Also, the increase in Italian supply in 2018, net of QE, should be smaller than that of several Eurozone issuers, including France and Germany.

The key immediate factor affecting Italian valuations are the national elections scheduled for 4 March. Briefly put, there are three broad types of political risk identified by investors.

- A 'hung parliament' with no single party or electoral coalition achieving a majority in both Chambers.
- Fiscal loosening in excess of the targets agreed with the EC, based on a number of electoral promises.
- Formation of a government that includes parties open to questioning EMU membership.

On the basis of recent polls, the lack of a clear, majority outcome seems quite high. However, that was the case after the 2013 elections which, after some initial jitters, did not prevent economic and financial convergence by Italy. Substantially reduced budget discipline does not seem likely, post elections, as long as the government remains broadly committed to EMU membership. The really crucial issue we see, as in the Dutch and French votes in 2017, is whether the new government is pro- or anti-EMU membership. Based on the likely distribution of votes and the stance of various parties, we believe that any substantive distancing between Italy and ECB orthodoxy is quite unlikely.

In terms of timing, past experience suggests that a more speculative minority will build long-BTP positions ahead of the vote, while other investors will clearly stand on the sidelines until well after. But, in very simple terms, with the exception of Greece in 2015, betting against periphery paper into elections has been a costly strategy. At current prices, we believe that BTPs should be a substantive portion of the long position we recommend EGB investors hold in periphery paper.

Shorter-dated core ASW tightening rather rapidly

As we wrote earlier in January "Core EGB Euribor spreads can tighten further, albeit at a moderate pace" adding that "we will see a 5-10 bp tightening in Bund swap spreads". Since then, the shorter maturities, (Schatz and OBLs) have experienced 3-5 bp of tightening while longer-dated paper has moved more gradually. For us, the key medium-term consideration, here, is still the fact that the APP has decelerated and will eventually end. However, there is arguably a directional dimension to the recent core bond underperformance, which would presumably be corrected once the pressure on outright rates decreases, in the near term.

Euro government bond supply: YTD update

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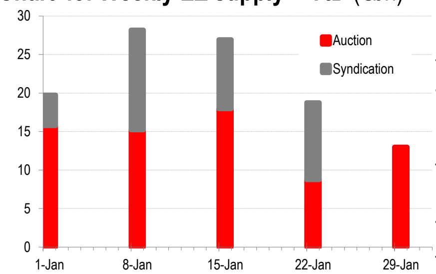
YTD combined bond issuance completion >10%

As expected, the beginning of the year saw ample govie supply, with EUR issuers selling a total of c.€107bn via both ordinary auctions (€70.7bn) and syndicated deals (€36bn). This figure is above the €100bn sold in the same period last year, with some issuers having been a bit quicker off the mark than in previous years (like Italy, with a new 10y BTP in the second week of January), amid record-breaking levels in capital markets and economic expansion across Europe.

Chart 43: Weekly EZ supply – YtD (€bn)



Source: Bloomberg, EZ countries' debt agencies.

In terms of averages, the Eurozone logged weekly issuance of €21.3bn in January. The largest volume of supply was seen in the week commencing 8 January, with €28.2bn placed; including syndications (see Chart 43).

By country, Portugal (27%), Ireland and Austria (tied at 25%) are the furthest ahead in terms of YTD completion, followed by Belgium and Spain (also tied at 16%). Italy (13%), France (11%), Germany (10%) come next. The Netherlands has only reached 7% completion, while Finland is at the tail-end of the ranking as it has not begun issuing debt yet (see Table 3).

Table 3: Total issued in EZ in 2018, by country (updated as at 31 January)

	GE	FR	NE	AS	SP	BE	PO	IT	IR	FI	TOTAL EZ (€bn)
YtD auctioned issuance	16.0	21.7	1.9	1.4	10.6	0.0	0.0	19.2	0.0	0.0	70.7
YtD syndicated issuance	0.0	0.0	0.0	4.0	10.0	5.0	4.0	9.0	4.0	0.0	36.0
YtD Issuance	16.0	21.7	1.9	5.4	20.6	5.0	4.0	28.2	4.0	0.0	106.7
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)	10%	11%	7%	25%	16%	16%	27%	13%	25%	0%	13.0%

Source: Bloomberg, EZ countries' debt agencies

Table 4: YTD issuance completion vs. historical data

	2013	2014	2015	2016	2017	2018	Aver 13-17
GE	10%	9%	12%	7%	7%	**10%**	9%
FR	9%	10%	11%	10%	13%	**11%**	11%
NE	10%	10%	10%	5%	11%	**7%**	9%
AS	5%	5%	6%	6%	11%	**25%**	7%
SP	14%	16%	13%	16%	13%	**16%**	15%
BE	9%	15%	14%	12%	16%	**16%**	14%
PO	45%	19%	28%	23%	21%	**27%**	27%
IT	10%	9%	11%	7%	10%	**13%**	9%
IR	33%	32%	30%	35%	24%	**25%**	31%
FI	7%	33%	0%	12%	0%	**0%**	11%
TOTAL EZ (€)	**11%**	**11%**	**12%**	**10%**	**11%**	**13%**	**11%**

Source: Bloomberg. YtD (calendar year) data for 2018. January aggregates for historical data.

In term of numbers, as highlighted above, Euro area issuers have placed €106.7bn. Italy is at the forefront, with €28.2bn of BTPs and linkers, France is in second place, with €21.7bn of OATs and linkers, Spain comes third, with €20.6bn of debt issuance, and Germany is close behind, with €16bn. The rest are still short of the €10bn mark, but are picking up pace towards completing their targets for this year.

As shown in Table 4, Austria, Spain and Italy have set new record highs for the last five years in terms of bond issuance completion at this point of the year, at 25%, 16%, and 13%, respectively. On the other hand, Finland has not started yet, with this year's standstill also seen twice in the last five years. When comparing 2018 to last year's completion rates, Austria is ahead, exceeding its 2017 average by 14pp, followed by Portugal (+6pp), then Spain and Germany (both +3pp). France and the Netherlands are lagging behind last year, by 2pp and 4pp, respectively. The rest are issuing at a similar or slightly faster pace than in 2017

Focus on syndications at the beginning of the year

Table 5: Syndicated deals in January

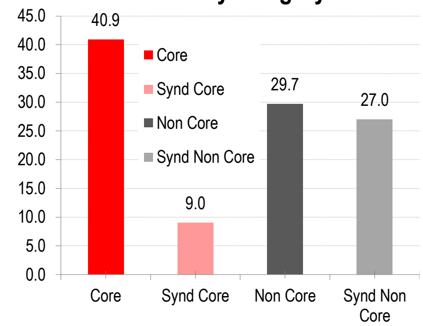
Issuer	Date	Size (€bn)	Maturity Date	Price (bp)	Coupon
IR	03-Jan-18	4.0	15-May-28	MS+2	0.90%
IT	10-Jan-18	9.0	01-Sep-38	BTPS+16	2.95%
PO	10-Jan-18	4.0	17-Oct-28	MS+114	2.125%
EF	10-Jan-18	6.0	17-Feb-25	MS-16	0.40%
BE	16-Jan-18	5.0	22-Jun-28	MS-17	0.80%
AS	18-Jan-18	4.0	20-Feb-28	MS-18	0.75%
SP	23-Jan-18	10.0	30-Apr-28	MS+46	1.40%
EF	24-Jan-18	2.0	17-Oct-23	MS-21	0.13%
		2.5	05-Sep-40	MS+3	1.45%

Source: Bloomberg, EZ countries' debt agencies

As is usual in January, some issuers have already opted to launch new bonds via this route, taking advantage of current market conditions and investors' appetite for sovereign bonds. As shown in Table 5, issuers actually started coming to the market with syndicated deals very early this year, with Ireland selling €4bn of 10y bonds at 2bp over mid-swaps on 3 January. Italy, earlier than usual, sold a new 20y syndicated bond for €9bn at the corresponding BTP + 16bp, while Portugal, on the same day, raised €4bn through the launch of a new ten-year PGB. Belgium (on 16 January) followed with another 10y syndicated bond, with €5bn placed at MS-17bp. Two days later, Austria also took the syndication route, selling €4bn of a 10y government bond at MS-18bp. Then, on 23 January, Spain sold €10bn via the syndication of its new 10y SPGB at a spread of 46bp over mid-swap levels, breaking its order book record from 2014.

Note that the EFSF also opted for syndicated deals on 10 January, (when it sold €6bn of a new 7y bond priced at MS-16bp) and 24 January (when it tapped two bonds for a combined €4.5bn). In January alone, the EFSF has issued €10.5bn, much more than the €3bn placed in the same month last year, reaching 72% of its 2018 target.

Chart 44: Issuance by category – YtD

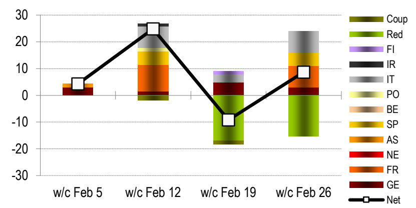


Source: European Commission, EZ countries' debt agencies, Bloomberg, Santander

Periphery issuance slightly higher than core supply

Periphery supply, including syndicated deals accounts for more than 53% of the total issued YTD, ahead of core issuance (46.8%). In terms of amounts issued so far via syndication, non-core countries have placed 3x more than their core counterparts (€27bn vs. €9bn), while the core countries have auctioned 1.4x more than the periphery bloc so far this year. In January 2017, periphery sovereigns issued €52.8bn (€22bn via syndication, €30.8bn auctioned). This figure compares with the €56.7bn (€29.7bn through auctions and €27bn via syndicated deals) placed by non-core countries this January, largely explained by both Spain's and Italy's successful syndicated deals. For their part, the core bloc issued €50.9bn in January 2017, which is slightly more than the €49.9bn seen this January.

Chart 45: Expected net EUR bond supply (€bn)



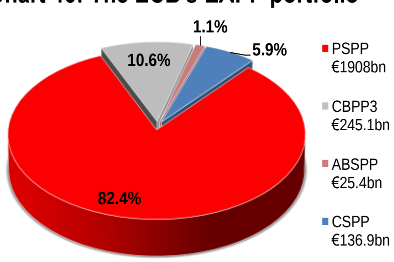
Source: Bloomberg, Santander.

Supply dynamics: Positive net EUR supply in February

In the next four weeks, we expect more than €60bn in new auctions, with Italy, France and Germany set to issue €19bn, €18bn and €12.5bn, respectively, on our numbers. Italy might introduce a new benchmark or linker through a syndicated deal, Spain may sell around €8-9bn, while Austria, Belgium, Ireland and the Netherlands also plan to sell bonds this month. All this supply will be partly offset by over €32bn in redemptions and more than €3bn in coupon payments in February. Consequently, EUR net issuance will be in positive territory by €28bn (Chart 45).

Update on the ECB's EAPP

Chart 46: The ECB's EAPP portfolio



Source: ECB, Bloomberg, Santander.

The latest report published by the ECB on its Extended Asset Purchase Programme (EAPP) holdings, including the purchases settled as at 26 January, shows the ECB has accumulated €2.3trn in assets since the programme began in 2014. According to the report, the PSPP portfolio has a total of €1.9trn in Euro govies, supras, and agencies accounting for 82.4% of the ECB's monetary policy portfolio. CPBB3 holdings now amount to €245.1bn, which represents 10.6% of the portfolio, while the CSPP has reached c.€137bn (5.9% of the total) and, lastly, the ABSPP now stands at €25.4bn, making up the remaining 1.1%.

Country-wise, the latest information available is the breakdown of PSPP debt security holdings the ECB published on 3 January. In summary, the figures show that Public Sector purchases totalled €46.2bn, €41.6bn of which were EUR govies (a €4.1bn decrease vs. November) and the rest was supranational debt (down €452mn). As already pre-announced, the December purchases slowed down over the holiday period, falling short of the €60bn target, similar to the situation in 2015 and 2016. However, the frontloading seen over September-November completely offset the decline in December and the monthly average since April 2017 is close to the €60bn target (€59.5bn/month).

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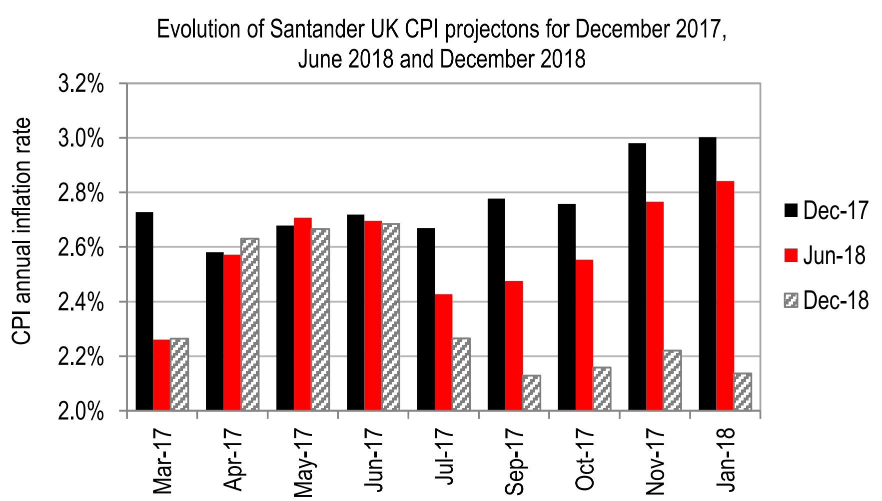
- **UK CPI inflation likely peaked in November 2017…**
- **…but the recent strength of energy prices is likely to delay the long-awaited decline in UK inflation until H2-18**
- **MPC focus will remain on domestically-generated inflation, but we see little evidence of building price pressures.**

UK inflation's decline delayed, not postponed

The path of consumer price inflation will inevitably exert a major influence on market sentiment with regard to both UK monetary policy and GDP growth more generally through 2018, and we are confident that the 3.1% rise in CPI over the year to November 2017 represents the peak for the current cycle. However, rather than declining at a steady, even pace through the course of the coming year, we increasingly expect 2018 to prove a 'year of two halves' for UK inflation, with the bulk of the anticipated fall in headline inflation seen occurring from July onwards (see Chart 47). Moreover, we do not believe that a simple focus upon core, rather than headline, inflation is likely to accurately reflect the trends scrutinised most by policymakers, and we expect the Monetary Policy Committee (MPC) to focus increasingly upon the outlook for domestically-generated price pressures as inflation overall declines.

In the text below, we outline our key thoughts on the outlook for UK inflation in 2018, focusing upon: (i) the trends in exchange rate-related price growth, (ii) the potential for energy prices to support headline inflation in H1-18, (iii) the outlook for domestically-generated inflation, and (iv) how a focused decline in price growth in H2-18 may work to support sentiment around UK consumer expenditure.

Chart 47: Our expected decline in UK CPI inflation has shifted progressively into H2-18



Source: Santander
Note: Chart shows the evolution of Santander's forecasts for the annual rate of UK CPI inflation in December 2017, June 2018 and December 2018. Dates on the horizontal axis relate to the publication date of Santander forecasts.

1. Pass-through effect still set for an early finish

First, we feel it important to stress that our expectations around the greater durability of UK inflation during H1-18 do not reflect any change in our assumptions around the exchange rate pass-through effect, or, in turn, the influence of the more import-sensitive areas of the inflation baskets. We believe that inflation within these areas of the data has already peaked.

Moreover, we continue to argue that the Bank of England's analysis of the exchange rate pass-through effect on inflation is perhaps biased by a failure to adjust the data surrounding the 2007 sterling depreciation for the distortion created by clothing prices during that period.

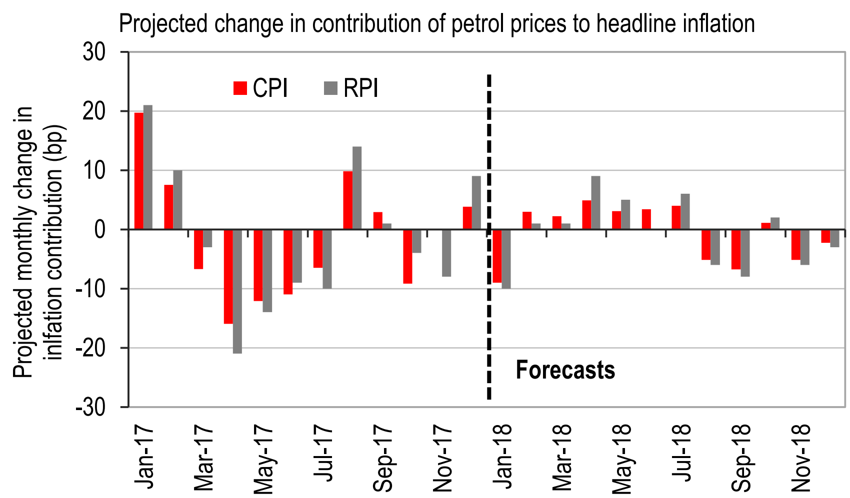
As such, while the Bank of England currently expects the H2-16 depreciation of the sterling exchange rate to support inflation for a period as long as four years, we believe that this influence will be largely exhausted within perhaps just two years, with inflation across the most import-sensitive areas slowing through the early months of 2018.

2. Rising petrol & utility prices to support inflation in H-18

Second, rather than reflecting any shift in view around the underlying inflationary performance of the UK economy, our recently increased CPI projections for H1-18 relate in large part to the rising trend of energy costs. This factor reflects both the increase in petrol prices already observed, and our continued assumption of a further increase in utility prices being delivered during the early months of 2018.

In sterling-denominated terms, crude oil prices have now risen by approximately 40% from the (recent) lows recorded in June 2017. The large tax wedge surrounding UK petrol prices has worked to limit the immediate impact on retail petrol prices, and consumer price inflation in turn. But the base effects created by rising petrol prices in early 2018 –in contrast to the declines registered during Q2-17– are nevertheless expected to prove a considerable source of volatility within the headline inflation data over the coming months. Our current forecasts call for the inflation contribution of petrol prices to CPI inflation to fall from 15bp in December 2017 to 9bp in February 2018, before then climbing steadily to an estimated 27bp in July 2018 (see Chart 48). In addition, the expectation of rising utility prices in Q2-18 accounts for a further c20bp boost to both CPI and RPI inflation, working to offset the impact of fading price growth across other areas of the inflation basket.

Chart 48: Estimated contribution of petrol prices to headline CPI & RPI inflation



Source: ONS, Santander.
Note: Chart shows calculated monthly change in the contribution of petrol prices (in bp) to the headline annual rates of CPI and RPI inflation. Estimates for the period December 2017 to February 2018 are as stated in the text. We assume that prices remain unchanged from March 2018 onwards.

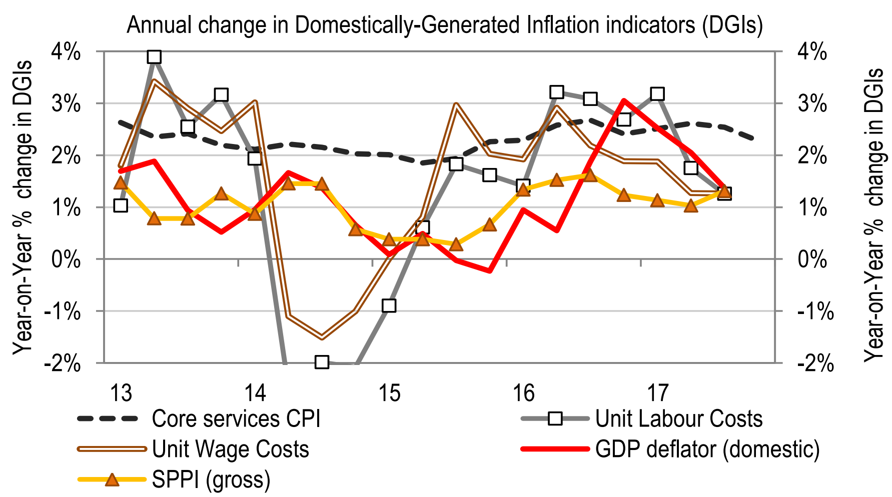
3. Domestic pressures expected to remain subdued

While the trends in energy markets appear set to support goods price inflation in H1-18, we look for a more stable and ultimately weak level of service price inflation to sustain through the course of the current year (and beyond). Indeed, we believe that the failure of services inflation to show any sustained signs of acceleration was arguably the most remarkable feature of the 2017 UK inflation data. For example, the ONS measure of services CPI registered a 2017-low in the December release, while our own calculated measure of core services inflation –which excludes the air fares, education and package holiday components– fell to just 2.21% in December 2017, the weakest rate recorded since October 2015.

Of course, such figures could primarily reflect the lagged impact of weak wage growth, and so policymakers would continue to watch for an acceleration of services inflation, even if the start point for any such advance is now lower than may have been reasonably expected. Some aspects of the recent labour market data may indeed point to an acceleration of pay growth in the coming months, in particular the latest figures relating to the relative shifts within short- and long-term unemployment.

But, from a broader view, we believe that the various indicators of domestically-generated inflation remain at very subdued levels. We would also highlight the previously poor predictive powers of indicators such as the output price component of the services PMI (which has moved higher in recent months). Chart 49, for instance, details the declining trend in unit wage and labour cost inflation, as well as the continued weak level of inflation implied by the domestic elements of the GDP deflator and the services producer price figures. Looking ahead, the apparent rebound in employment growth in the three months to November is likely to pressure reported productivity growth and unit labour cost inflation in turn. But, we nevertheless believe that the onus is now on measures of domestically-generated inflation to show clear signs of acceleration in 2018 in order to justify policymaker concerns, rather than there being any need for domestic inflation to slow in order to prevent an offsetting move in monetary policy.

Chart 49: Most measures of domestically-generated inflation are currently in decline

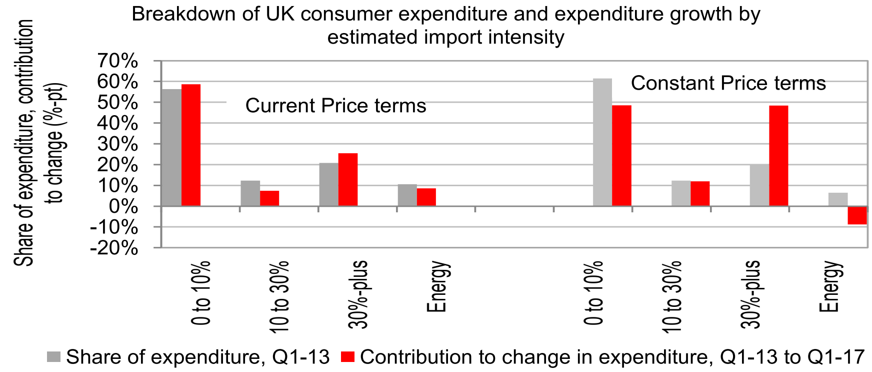


Source: ONS, Thomson Reuters Datastream, Santander.
Note: SPPI (gross) relates to the services producer price index, including transactions between companies in the same sector.

4. Focus of inflation decline set to boost consumption

The final area of our key expectations around UK inflation in 2018 relates more to GDP rather than price growth per se, and the potential for real terms consumer expenditure growth to receive a disproportionately large boost in H2-18, should import-intensive inflation ease in line with our forecasts.

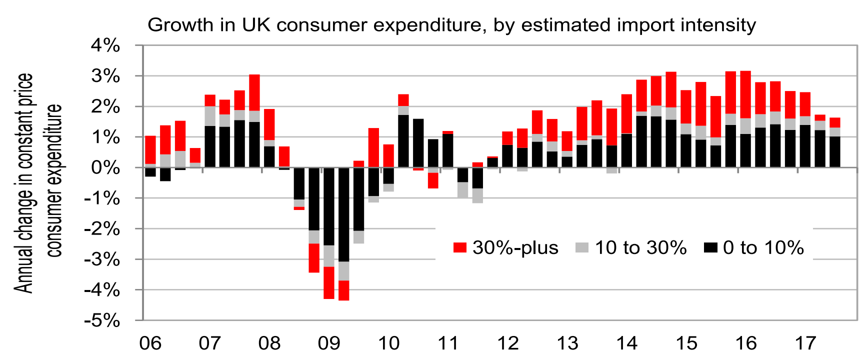
Chart 50: On a real terms basis, most growth in consumption came from the high import-intensive areas of spending, with the opposite being the case in nominal terms



Source: ONS, Thomson Reuters Datastream, Santander.
Note: Chart shows breakdown of UK consumer expenditure by estimated direct import intensity in Q1-13, and the contribution of each category to the growth recorded between Q1-13 and Q1-17. Data presented in both current and constant price terms.

In our September 2017 research publication, '[UK Consumption: What's the real story?]', we outlined how the move to deflation, and then inflation, within the most import-sensitive areas of the UK inflation basket had worked to first boost and then reduce the reported rate of real terms consumer expenditure growth (even while expenditure growth remained stable in nominal terms). Although this relationship between inflation and the relative trends of nominal / real growth appears tautological, Charts 50 and 51 provide an insight into the specific influence of the most import-intensive areas of household spending in boosting the reported rate of real terms consumer expenditure growth between 2013 and 2016. In particular, Figure SG5 highlights the recent, very sharp reduction in the contribution to the annual growth rate of consumer expenditure from those goods and services with an estimated, direct import intensity of more than 30%.

Chart 51: The trend of import-intensive inflation has been a key driver of real terms consumption



Source: ONS, Thomson Reuters Datastream, Santander.
Note: Chart shows the annual change in constant price consumer expenditure, with a breakdown of this growth by estimated direct import intensity.

Overall, we believe that the above neatly illustrates the importance of relative price trends, rather than any volatility within nominal spending, to the reported shifts within the different categories of consumer expenditure. Indeed, with investors likely to remain concentrated upon real terms measures of expenditure, the prospects for a shift in sentiment around the UK consumer could well rest, in the first instance, on a decline in imported price pressures. We believe that the available evidence supports this prospect, and expect this slowdown in imported price pressures –and the support this offers for the reported growth in real terms consumer expenditure– to become obvious over the course of 2018.

UK Rates Strategy: Belatedly –but sharply– joining the sell-off

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- **Politics and Brexit have made noise but little progress this month**
- **Nor have domestic macro data shown clear direction for 2018 yet**
- **The strongly bearish tone on other markets has been dominant…**
- **…and UK rates have now overshot the gradual moves elsewhere**
- **The BoE is likely to keep talking hawkishly, while doing little**
- **We expect the front-end rates curve, and gilt spreads, to steepen**

Close trade idea: pay 5y5y GBP versus USD and EUR.
We recommended this trade on 12 January. Its spread surged this week, touching −84bp, and remains through our target of −90bp.

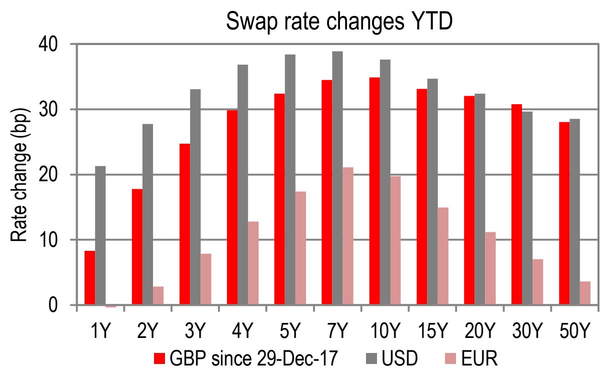
Upbeat global conditions take UK rates along for the ride…

UK rates headed steadily higher during January, and accelerated sharply towards the end of the month. We largely attribute this to pushes and pulls upwards from interest rates elsewhere, rather than domestic developments. Some small upside surprises in UK macro data will no doubt have helped, but the largest moves were not triggered directly by data or news flow.

The wait for clarity of progress (or even intent) around Brexit helped prevent the UK rates market from building up too much conviction or momentum, although the FX market seemed less inhibited. If anything, we read the news towards the end of January as making the next round of negotiations look more challenging: the EU's official negotiating directives and commentary are taking a hard line, and the UK government has yet to show any inclination to blur its own declared "red lines".

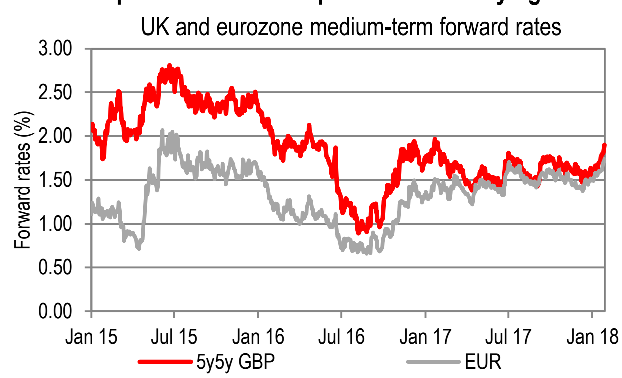
Nonetheless, markets appeared to remain optimistic that any economic disruption will be very limited, and the rises in rates elsewhere eventually overcame the GBP market's caution. UK term rates are now at their highest for two years, well clear of the ranges they had held to since the EU referendum. They have lagged the more determined moves in the US: the 10y USD-GBP swap differential came within 2bp of its all-time widest on 19 January (admittedly, that 132bp record was only set last March), although this has now fallen back to the ~115bp that prevailed either side of new year.

Chart 52: So far this year, UK rates have been caught between the sell-offs in the US and the Eurozone…



Source: Bloomberg, Santander.

Chart 53: …but forward rates remain below January 2017's highs, and their spreads over EUR equivalents are very tight



Source: Bloomberg, Santander.

The UK has done a better job of keeping ahead of the rises in EUR rates, and has actually widened its lead since the turn of the year (Chart 52). These spreads remain historically quite tight, especially for forward rates as they are not so pinned by the base rates' different starting points (Chart 53).

The UK's outright 'underperformance' also looks less significant when adjusted for EUR rates' much lower delivered volatility (thanks to the tranquilizing influence of the ECB): we find the 5y GBP rate to have a Z-score of 2.8 versus the last 12 months, whereas USD and EUR rates score 3.3 and 3.6, respectively.

… but the recent catch-up should be more than enough

Our call for UK rates in the last, Year Ahead, edition of Interest & Exchange was for an upward direction driven by global developments, restrained and later even reversing due to the unique Brexit uncertainties hanging over the UK. So far, this narrative appears to be playing out as expected, and our UK forecasts have barely changed in this edition. We still expect GBP to outperform both USD and EUR rates over 2018 as a whole, but to take a far from direct path.

UK rates were lagging well behind the moves elsewhere in mid-to-late January, but have since moved sharply to make up lost ground. If anything, we now see their sell-off as having overshot fair value, and as having started February looking slightly too cheap, especially versus the Eurozone. On top of this relative revaluation, we see event risks as biased in favour of resumed outperformance, and a further convergence with Eurozone rates.

Reports of a marked deterioration in the Brexit process would seem to us the most likely potential trigger for GBP rates to resume their outperformance, but we believe the negotiations are currently in a low-key, technical stage that reduces the chance of major news, either way, in the near term. Internal UK politics also presents potential risks, but we believe a perception of improvement on the stasis that pervaded January is more likely than an acute crisis, for now, at least.

The tone of UK economic data has been broadly neutral so far this year, with small upside surprises, such as employment creation and 4Q17 GDP, offset by disappointments, from mortgage growth and the Manufacturing PMI. The market has been fairly insensitive to these releases so far this year, although that may change if a clearer pattern of good, or bad, news starts to emerge. Wage growth and its implications for domestically-generated inflation is particularly crucial, especially for the MPC, and we set out our (subdued) expectations on that front in the UK Economics section of this report, above.

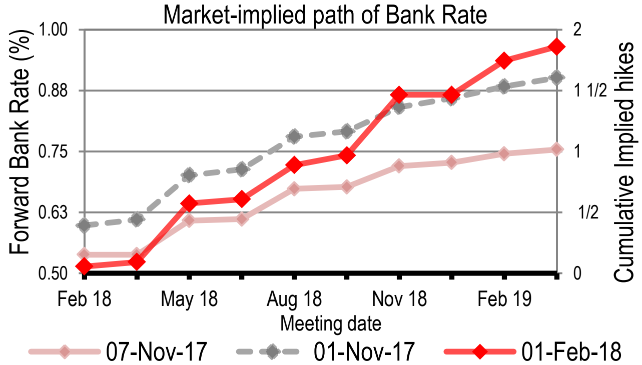
BoE hiking cycle expectations can keep building

On the monetary policy side, we see the short-run risks around the BoE as biased to a more assertively hawkish message. Short sterling rate expectations would likely also experience additional upward pressure if our call for short USD rates to keep rising proves correct, albeit with weaker transmission than between their longer-term rates.

Market expectations around the BoE have remained well-contained, largely accepting MPC members' hints that they have one hike a year in mind – the latest sell-off has brought August in to play for the first time since November's 'dovish hike' (Chart 54). Next week's Quarterly Inflation Report will be key for assessing the BoE's likely path, but we see its risks to rates as biased towards higher and steeper from here.

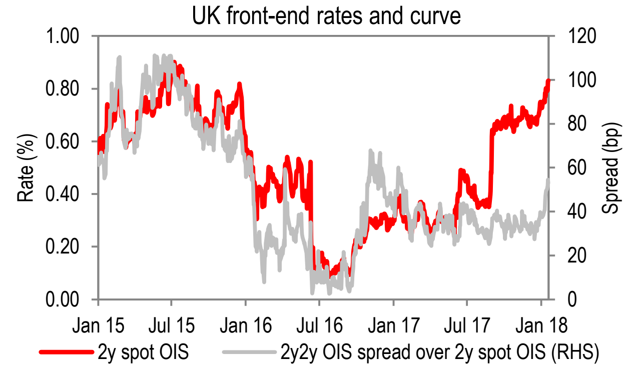
Forward rates had been implying considerable scepticism that this 'cycle' will go very far, though, with the third hike staying only fuzzily priced around 2021 until mid-January. Steepening then took hold much more suddenly than the grind higher in the shortest rates: the difference between 2y and 2y2y OIS rates leapt by over 10bp in the week between 23 and 30 January, after holding to the 28-42bp range seen since February 2017 (Chart 55).

Chart 54: Bank Rate expectations have remained roughly within the range of levels they established back in November, but have begun to steepen out of that corridor



Source: Bloomberg, ICAP, Santander. 1 and 7 November marked the recent high and low for UK short rates, overall.

Chart 55: Beyond the shortest horizons, UK rate expectations have only very recently started to include an extended hiking cycle, and it remains much more limited than on previous occasions



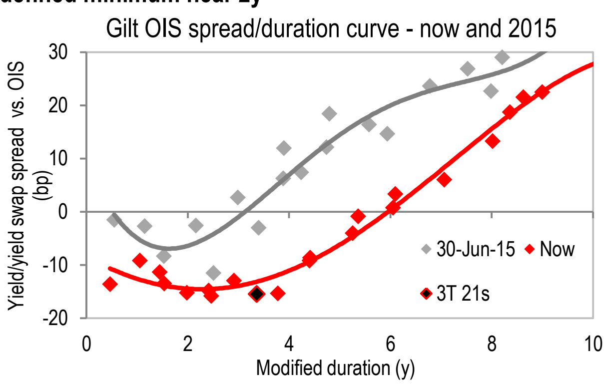
Source: Bloomberg, Santander.

UK short rates now appear likely to behave quite similarly to EUR ones, with the Central Banks (and Brexit negotiation period) keeping the front couple of years well anchored, but with more scope for markets to swing around beyond that. Even after last week's jump, the OIS curve is only implying that rates between two- and four-years' time will average two hikes above those over the front two years: barring the shocks we mentioned earlier, more 'normalization' seems likely to become anticipated than that. This is a picture of a very short hawkish journey, which is emphasised by comparing the slope of forward rates with those that prevailed during 2015, the last time that Bank Rate was expected to break the long-standing 0.50% ceiling (Chart 55).

The room for further rises we see in 2-5y GBP rates makes for a contrast with our more bullish view on EUR equivalents (explained in the Euro Rates Strategy section, above). This strikes us as a good sector for tactical plays on further GBP underperformance, rather than longer tenors. The relative steepness of the front end of the EUR curve also gives a 2y2y widener very favourable roll-down (~5bp over three months).

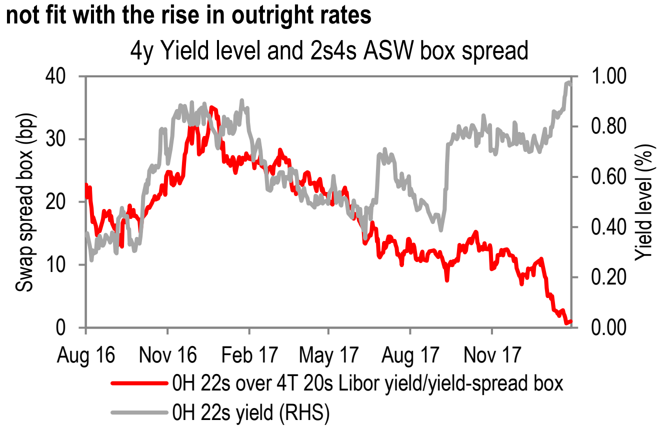
To be clear, we still expect the MPC to ultimately leave Bank Rate unchanged over the next two years, as imported inflation fades, domestic inflation (wages) fails to accelerate, but growth and confidence stutter. But 'normalization' is likely to remain 'just around the corner', and the MPC has generally seemed more comfortable with a firmly upward-sloping curve.

Chart 56: The gilt spread curve now only turns upward beyond 4y durations, whereas there is typically a more clearly defined minimum near 2y



Source: Bloomberg, Santander.

Chart 57: The strong recent flattening of short gilt spreads does not fit with the rise in outright rates



Source: Bloomberg, Santander.

The gilt spread curve also looks anomalously compressed

We reviewed recent UK swap spread developments in a Gilt Spread Focus on 29 January. Our main conclusion was that the front end of the spread curve is too flat compared to profiles at previous periods with a similar rate expectation profile (Chart 56). The recent spread flattening came despite the outright yield curve in this region remaining stable until the modest recent steepening (discussed above), and a historical co-directionality with outright rates that implies spreads should be steepening rather than flattening (Chart 57). Separately, the valuation premium previously seen in high-coupon issues has almost disappeared, and we do not see it as likely to return.

We recommended box steepeners such as buying 4T 20s vs. 3T 21s or 0H 22s or, for non-leveraged and long-only ASW investors, moving positions out of the 3-5y region. We have long seen the 5% 25s, for instance, as cheap.

We also recommended taking profits on the 10s30s ASW flattener we recommended at the start of December: we do not expect a reversal of the long-end widening, but see further upside as limited from here.

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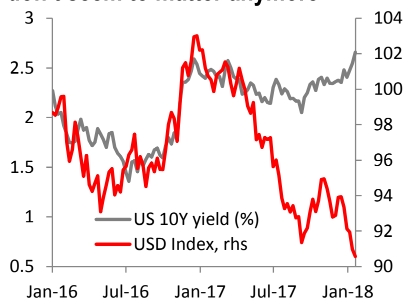
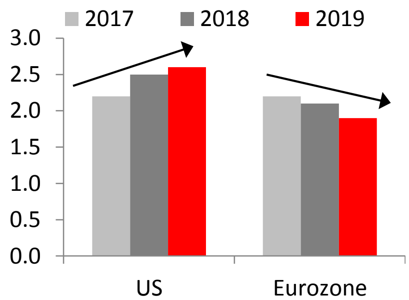
Taken from our latest FX Compass, published 25 January

Chart 58: Yields and spreads just don't seem to matter anymore



Source: Bloomberg, Santander

Chart 59: Santander GDP forecasts: US v Eurozone



Source: Bloomberg, Santander

USD – Enough is enough?

We still think that the market is too negative on the USD. US political concern, evidenced by the brief government "shutdown", is a clear negative for the currency, as are signs that the administration is not too bothered by a weak USD. But, the combination of a strong US economy, higher US interest rates and wider policy divergence vs. its peers, should provide support.

The USD has started 2018 in much the same way as it ended 2017, namely weak. The dollar is down against all of its developed-market peers so far in January. Indeed, the small gains that it posted against the JPY and GBP in December have more than reversed. Consequently, the momentum trade still appears to sell the USD. Indeed, in January, the dollar has only posted gains in excess of 0.1% against the Argentine peso. In our opinion, such USD pessimism appears excessive and at odds with the fundamental and monetary policy backdrop.

We are not suggesting that there is no justification for the market's USD negativity. Concerns over the political and policy outlook persist, as is clearly reflected by the administration's failure to agree a funding plan on time, resulting in a brief government shutdown, the first since 2013. Further, Treasury Secretary Mnchuin's comments at Davos that "a weaker dollar is good for trade", may imply little political push-back, at least from the US, to an even weaker USD.

However, whilst the shutdown appears an obvious dollar-sell signal, the currency actually held up comparatively well in the immediate aftermath. Perhaps this resilience in the face of such clear, and unexpected, uncertainty provides a sign that the sell-USD trade may start to run out of steam?.

Moreover, we can but reiterate the factors which we think should, even though they have failed to do so thus far, act as a brake on further USD weakness. The main support should be US yields and the outlook for US monetary policy compared to other developed-market currencies.

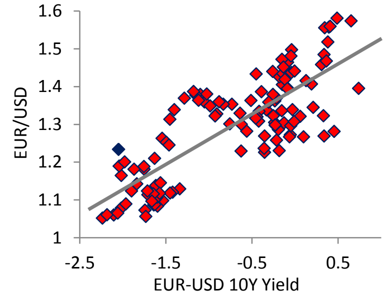
As we highlighted in "Brakes on for the USD as an unsustainable divergence from rates start to weigh?", published on 16 January, many of the USD pairs, crucially including EUR/USD, appear to have diverged, and are weaker, than the spreads at both the short and long ends of the curve would suggest.

The FX market, consumed by USD negativity, has preferred to focus on the possibility that the ECB and other central banks may adopt a less loose monetary policy, rather than the imminent Fed rate hikes. In essence, we believe monetary policy divergence is currently USD positive and implies the USD has been oversold. The outlook for monetary policy and yields is also USD positive.

The economic backdrop also remains USD supportive. Admittedly, Eurozone policymakers are more upbeat on the region's economy, but we think this should already have been priced via the EUR's gains. Meanwhile, the US economy is still expected to outperform, both this year and next. In addition, both US headline and core inflation are much higher than the Eurozone's. US core CPI was 1.8% YoY in December vs. Europe's 0.9% YoY, with the strong EUR pointing to the risk of this gap widening.

EUR – The glass looks full

Chart 60: Higher US yields should temper further EUR/USD gains



Source: Bloomberg, Santander. Monthly data since 2008. Blue is the latest data.

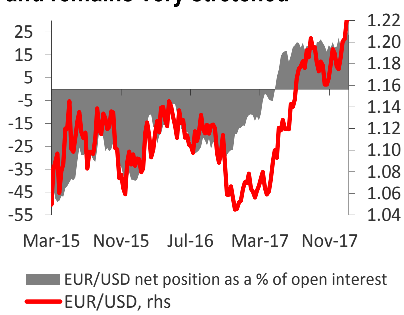
The EUR has continued to strengthen in January, or as the USD weakened! As such, we have revised our forecast profile for 2018 slightly higher, to reflect the rise in spot. We now expect EUR/USD at 1.21 in Q1, up from 1.15, at 1.22 at end-H1, up from 1.17, and at 1.26 at the end of 2018.

However, our central story remains the same: we believe that the EUR has been overbought, more so given the recent rise. The combination of a crowded long EUR trade, US rate hikes throughout 2018, sluggish Eurozone CPI and signs of ECB concern about persistent EUR strength should slow down and reverse EUR gains, in our view.

The Eurozone recovery has continued, supporting EUR sentiment. Business confidence indicators remain around record highs and unemployment is falling. However, we reiterate that economists still expect the Eurozone's recovery to be more than matched by the US's. Indeed, US growth is still expected to outperform the Eurozone's in 2018 and 2019, with the consensus expecting US GDP growth of 2.6% this year and 2.1% in 2019, compared to 2.2% and 1.8%, respectively, for the Eurozone. Hence, the relative growth story should caution against being too long EUR/USD.

The market was far too pessimistic on the EUR at the start of 2017, in our view, focusing on politics, economics and monetary policy. As these fears faded, the EUR rightly rebounded. However, there are signs that it is in danger of rebounding too far, and that it has already priced in the improved macro backdrop.

Chart 61: The long EUR/USD position has been a good indicator for the pair, and remains very stretched



Source: CFTC, Bloomberg, Santander

For example, the IMM non-commercial position data for the week ended 9 January showed that the speculative net-long EUR/USD position was at an all-time high in absolute terms. The rise in long positions explains much of the EUR's gains. The correlation between the net EUR/USD position and EUR/USD has been 0.93 since the start of 2017. Consequently, if speculators continue to add to this position, the EUR looks certain to rise in the near term.

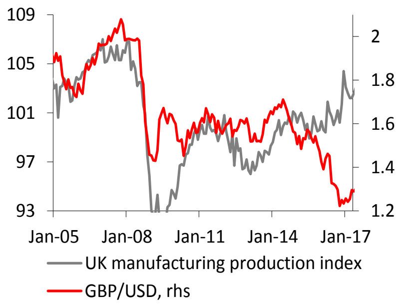
However, these speculative data tend to be viewed as a contrarian indicator. For instance, with the market already long the EUR, there should be less appetite to add to that position. The bullish EUR glass appears full. Possible profit-taking and unwinding of these positions could pull the EUR notably weaker in Q1-18.

A possible catalyst for the unwinding of EUR longs is signs that the ECB is becoming concerned about the impact of the strong EUR. Recently, the ECB's Constancio and Villeroy commented on the EUR. Plus, Draghi, at the January ECB meeting warned that EUR 'volatility' creates uncertainty, but this warning wasn't strong enough to prevent the EUR strengthening. Even so, we expect the Bank to be mnore vocal about the rise of FX strength over the coming weeks, if only to instil some two-sided risk in to the EUR.

In addition, we feel that the monetary policy outlook does not justify the recent scale of EUR strength. Draghi confirmed that asset purchases will remain in plase until September, and could be extended. Further, he sees very few chance of a rat ehike this year. Meanwhile, December's CPI data showed core CPI dipping to 0.9% YoY, whilst US core inflation is 1.8%. Hence, the Fed is expected to hike in March, and follow that up with –what should be– further USD-positive rate hikes over the remainder of the year.

GBP – Brexit, what Brexit!

Chart 62: Sterling playing economic catch-up?



Source: Bloomberg, Santander

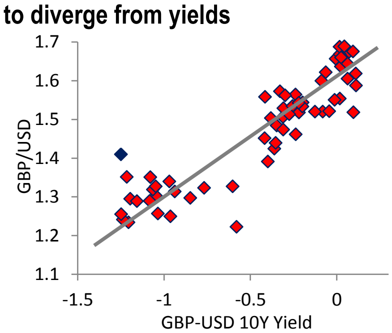
The Pound has posted a notable recovery against its developed-market peers over the last few months. We are sceptical about whether this will continue, and still see the Pound as vulnerable (indeed, even more so, given the extent of its recovery). However, the jump in the spot level has forced a revision to our forecast profile. We now expect GBP/USD at 1.39 in Q1, up from 1.30, at 1.36 at end-H1 up from 1.28, and at 1.32 at the end of 2018.

It has been a very positive few months for the Pound. To place things in context, over the last three months Sterling has strengthened against all the major currencies, is broadly flat against the COP and PLN, but has only recorded notable losses against the ZAR.

Why the rebound? 1) The market is currently less nervous about Brexit; 2) the post-EU referendum sell-off from June 2016 implied the Pound looked cheap in relation to current UK fundamentals; and 3) the USD has weakened, boosting GBP/USD.

We have highlighted, for several months now, that whilst Brexit/political uncertainty was a justifiable constraint on the Pound, the currency was much weaker than UK economic data suggested it should be. We estimate that, given the historic link between UK joblessness and the Pound, the weak GBP was pricing in unemployment of over 8%, compared to the current 4.3%. Hence, a degree of the recent move may be the market pricing out such 'over' pessimism. The successful conclusion of the first phase of the Brexit negotiations in December will have helped here.

Chart 63: GBP/USD strength starting to diverge from yields



Source: Bloomberg, Santander. Monthly data since 2008. Blue is the latest data.

However, the rebound in GBP/USD owes a lot to the ongoing dollar sell-off, rather than UK-specific factors. The correlation between GBP/USD and the USD index has been -0.95 over the last three months. In addition, EUR/GBP has tended to move sideways, as a stronger EUR/USD, again helped by the weak USD, has cancelled out the stronger GBP/USD.

Can Sterling, in particular GBP/USD, continue to strengthen? Yes. Whilst Cable's appreciation over the last three months is impressive, it has not happened at a pace that we would consider excessive and, therefore, at risk of a reversal. Plus, speculators' long GBP/USD position is still relatively small, with plenty of scope to be added to over the coming weeks.

However, other barriers may temper further Sterling strength. The economic outlook has held up better than most ecomists expected, but the UK is still forecast to underperform both the US and the Eurozone in 2018, growing by just 1.4%.

Plus, whilst there was scope for the Pound to rally as the post-referendum economic fears did not materialize, there should be a 'Brexit' ceiling on this reversal. GBP/USD averaged around 1.46 in June 2016, before the EU vote on 23 June. Further GBP/USD gains might take it close to ths level, almost implying that Brexit does not matter and uncertainty surrounding it is over. We would view this as premature, given that phase-2 talks are yet to start.

Moreover, we do not view the monetary policy outlook as a clear GBP positive. The market is pricing in a rate hike in November, but we think the BoE will hold off. Further, as with EUR/USD, the Fed is forecast to hike rates more aggressively in 2018 and 2019, which should be GBP/USD negative, as should the fact that the pair already appears overbought given UK-US yield spreads

Table 6: 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	1.22	1.24
GBP-USD	1.39	1.36	1.34	1.32	1.32	1.33
GBP-EUR	1.15	1.11	1.08	1.05	1.08	1.07
EUR-GBP	0.87	0.90	0.93	0.95	0.92	0.93
USD-JPY	114	116	117	118	120	122
EUR-JPY	138	142	145	149	146	151
USD-CNY	6.40	6.60	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	1.00	0.99
EUR-SEK	9.6	9.5	9.3	9.0	8.8	8.6
EUR-NOK	9.2	9.1	9.1	9.0	8.9	8.7
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	1Q18	2Q18	3Q18	4Q18
ECB Depo	-0.40	-0.40	-0.40	-0.40	-0.40
3m	-0.65	-0.70	-0.70	-0.65	-0.60
2y	-0.54	-0.50	-0.45	-0.35	-0.20
5y	0.11	0.00	0.00	0.05	0.20
10y	0.73	0.65	0.70	0.80	0.95
30y	1.38	1.40	1.50	1.65	1.75

Swap rate forecasts

€ swaps	Current	1Q18	2Q18	3Q18	4Q18
ECB Depo	-0.40	-0.40	-0.40	-0.40	-0.40
3m	-0.33	-0.33	-0.33	-0.31	-0.26
2y	-0.13	-0.10	-0.05	0.00	0.15
5y	0.49	0.40	0.40	0.45	0.60
10y	1.11	1.05	1.10	1.20	1.35
30y	1.61	1.65	1.75	1.90	2.00

US interest rate forecasts

Government Bond yield Forecasts

USTs	Current	1Q18	2Q18	3Q18	4Q18
FOMC (mid)	1.38	1.625	1.875	1.875	2.125
3m	1.47	1.65	1.85	2.00	2.25
2y	2.14	2.20	2.30	2.50	2.85
5y	2.56	2.65	2.75	2.90	3.15
10y	2.79	2.70	2.80	3.00	3.25
30y	3.03	3.00	3.10	3.20	3.50

Swap rate forecasts

$ swaps	Current	1Q18	2Q18	3Q18	4Q18
FOMC (mid)	1.375	1.625	1.875	1.875	2.125
3m	1.79	1.90	2.10	2.25	2.50
2y	2.35	2.35	2.40	2.55	2.85
5y	2.65	2.65	2.70	2.80	3.05
10y	2.82	2.70	2.75	2.90	3.15
30y	2.91	2.80	2.90	2.95	3.25

UK Interest rate forecasts

Government Bond yield Forecasts

Gilts	Current	1Q18	2Q18	3Q18	4Q18
MPC	0.50	0.50	0.50	0.50	0.50
3m	0.63	0.40	0.40	0.37	0.42
2y	0.67	0.60	0.70	0.40	0.50
5y	1.05	1.00	1.20	0.90	1.00
10y	1.57	1.60	1.80	1.40	1.60
30y	1.97	2.00	2.10	1.90	2.10

Swap rate forecasts

£ swaps	Current	1Q18	2Q18	3Q18	4Q18
MPC	0.50	0.50	0.50	0.50	0.50
3m	0.53	0.55	0.55	0.52	0.52
2y	0.96	0.95	1.05	0.70	0.80
5y	1.37	1.25	1.45	1.25	1.30
10y	1.64	1.65	1.80	1.50	1.70
30y	1.74	1.75	1.85	1.60	1.70

FX forecasts

	Current	1Q18	2Q18	3Q18	4Q18
EUR-USD	1.250	1.21	1.22	1.24	1.26
EUR-GBP	0.879	0.87	0.90	0.93	0.95
GBP-USD	1.200	1.39	1.36	1.34	1.32
USD-JPY	109.9	114.0	116.0	117	118
EUR-JPY	137.3	137.9	141.5	145	149

	Current	1Q18	2Q18	3Q18	4Q18
NZD-USD	0.737	0.72	0.70	0.71	0.72
USD-CAD	1.231	1.25	1.24	1.24	1.22
AUD-USD	0.800	0.78	0.76	0.76	0.77
EUR-CHF	1.160	1.16	1.17	1.18	1.20
EUR-SEK	9.82	9.60	9.50	9.3	9.0
EUR-NOK	9.57	9.20	9.10	9.1	9.0

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EXPLANATION OF THE RECOMMENDATION SYSTEM

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

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

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

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