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Interest & Exchange

Macro Slowdown and Safe Haven Flows

Global Strategy: Despite the relatively healthy global macro environment, it seems that the best days are behind us. This, together with multiple ongoing concerns, the end of QE (or actual tightening) and arguably still high valuations in some financial assets are causing significant safe-haven flows in the last quarter of the year.

US Macro: GDP growth has been positive in recent quarters, clearly supported by Mr Trump's fiscal package. However, although the money "received" by households and companies has had a positive impact so far, we find that not all of it has been invested/spent. In our view, higher investments and ultimately increased productivity growth rates could be key to keeping the economy growing above potential.

US Rates: Recent volatility confirms, in our view, that the road to higher yields in the US curve proves bumpy when changes happen too fast. Therefore, while we continue to think that we will see higher rates in coming quarters, the risk of sharp sell-offs persists, albeit contained. Interestingly, this volatility has had a significant impact on real rates and we are closing with profits our shorts on the 2y tenor, recommended last month.

EUR Macro: Job creation continues at a solid pace in the Eurozone, amid an improvement in indicators on the quality of the recovery in the labour market. In our view, this points to a clearer upswing in salaries to sustain households' income and sentiment.

EUR Rates: The process of policy and interest rate 'normalisation' was never going to be smooth and losses in equities are just one symptom. As in the US before, the Euro area market probably underestimates how much rates will rise in the future. Stresses in Italian debt are unlikely to result in a full-blown crisis but we remain underweight. Conversely, SPGBs are underpinned by solid economic results and we would be overweight.

GBP Macro: The October Budget proved to be a more significant fiscal event than had been expected, with Chancellor Philip Hammond effectively choosing to spend an unexpectedly large fiscal 'gift' from the OBR's updated projections all in one go. The debate around whether this Budget truly marks an end to austerity is likely incomplete, but faced with the choice of either reducing borrowing and debt, or instead opt for a fiscal loosening, the Chancellor has chosen the latter, more activist option.

GBP Rates: The Brexit process remains trapped in the "no deal, yet" scenario, with short rates roughly where we expected but long rates having outperformed markedly in the recent global rally. We expect UK rates to bear-steepen back, potentially starting with help from the Bank of England's MPC. We see 5y as the richest sector on the swap and gilt curves, whereas the 10y OTR gilt in particular stands to benefit from the Budget's surprisingly large cut to planned gilt supply.

G-10 FX: The USD is still dominant, helped by strong US economic data, rate hikes and struggling risk appetite. The strong dollar has weighed on EUR/USD, which has also been negatively affected by Italian budget concerns. We continue to expect that the pound should remain vulnerable in the short-term, given Brexit/political uncertainty.

Antonio Villarroya
Head of Macro and Strategy Research
antvillarroya@gruposantander.com

José María Fernández
Rates Strategist
josemariafernandezl@gruposantander.com

Edgar da Silva
Rates Strategist
efda@gruposantander.com

Antonio Espasa
European Chief Economist
aespasa@gruposantander.com

Beatriz Tejero
Economist
beatriz.tejero@gruposantander.com

Laura Velasco
Economist
laura.velasco@gruposantander.com
Banco Santander, S.A.
(+34) 91 257-2244 / 175 2289

Luca Jellinek
Head of Rates and FX Strategy
luca.jellinek@santandercib.co.uk

Stuart Green
UK Chief Economist
Stuart.Green@santandercib.co.uk

Adam Dent
UK Rates Strategist
Adam.Dent@santandercib.co.uk
Banco Santander, S.A. London Branch
(+44) 33 114 80 133 / 239 / 240

Stuart Bennett
G-10 FX Strategist
stuart.bennett@santandercib.co.uk

Michael Flisher
G10 FX Strategist
michael.flisher@santandercib.co.uk
Banco Santander, S.A. London Branch
(+44) 33 114 80 134 / 232

For a full list of contributors, please refer to page 34

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

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Santander Corporate & Investment Banking

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	USD	EUR	GBP
Economic Outlook	We have revised our GDP estimates for 2018 to 2.8% YoY (from 2.5%) and to 2.7% in 2019 (vs 2.6%) after including the effect of the fiscal reform. We expect a higher fiscal deficit and worse c/a balance.	1H18 GDP growth rates have surprised to the downside. Special one-off factors and global uncertainty would be behind that performance. We believe that c.2.0% GDP growth rates are still valid for the area.	We expect UK GDP growth of c.1.2% in 2018E, with investment constrained by ongoing Brexit uncertainty. Falling inflation should flatter real consumption growth in 2H18.
Monetary Policy / Front-End	The Fed is likely to continue hiking rates every quarter, but we believe it will not be able to raise rates as much as suggested by its dot plot..	We continue to expect the ECB to start raising rates in Sep-2019 and, once it starts, the pace might be faster than currently priced in by the market.	We expect Bank Rate to remain unchanged at 0.75% until at least the end of 2019, with growth & inflation data, plus rising Brexit risks, likely to frustrate the MPC's tightening bias.
Rates / Duration	The monetary policy normalisation, healthy macro environment and potential changes in the supply/demand equilibrium should weigh on USTs all along the curve.	The risk-off correction has boosted core EGBs. Longer term, bearish price action should return as ECB policy begins to tighten and the lag to US rates generates outflows from core EGBs.	Brexit exacerbated the global rates rally in the UK, but we think this was an overreaction and brace for a rebound in coming weeks - especially on any Brexit progress.
Curve / Slope	With our strategic front-end shorts now reaching our target, we recommend switching into 5s10s flatteners as a carry-efficient proxy for outright shorts.	Overall steepness has been highly directional, with the front end and longer maturities outperforming the middle of the curve when rates rise. Relative to that dynamic, anomalies are quite moderate.	Expect a steepening bias, with 5y looking particularly rich whereas 7y and 10y gilts have local appeal. Long end gilts look cheap on all metrics.
Spreads	Gradually unwinding SOMA reinvestments pose a risk for USTs. We like swap spread wideners (bearish USTs), especially at the ultra-long end.	BTP spreads overstate the likelihood of the Italy-EC stand-off leading to a credit event but Italy's long-term fiscal sustainability is in question. Spanish risk is much lower so contagion effects are an opportunity.	Brexit and EM concerns justify wide gilt ASW. The longstanding richness of 10y is continuing to leak out to shorter tenors, but 15y+ are appealingly tight.
Volatility	We find the top left corner cheap and the 5y5y area and the vega in most tenors a little rich, both compared to delivered and recent ranges.	The recent rise in realised vol has been reflected by implied vol. Upside for traded vol seems limited until the pace of the sell-off picks up.	Implied volatilities have bounced back from a trough in mid-September, but still look historically modest and do not fully reflect two-way Brexit tail risks.
Inflation / Break-evens	Cash breakevens remain attractive at the front end, especially when compared to the YtD increase in core CPI.	Traded inflation levels have corrected slightly lower and remain below current inflation and the ECB's target. Until core measures start rising more quickly, upside for break-evens looks limited.	August's upside inflation surprise looks like a one-off and wage growth are unlikely to accelerate, leaving front-end breakevens (still) too high.
FX	The USD remains firm. Political and trade concerns may still have an impact but the mix of a strong economy and further Fed rate hikes should provide support going forward.	Eurozone risks are again weighing on the EUR. However, a firm economy, higher inflation and a less pessimistic ECB should caution against over-selling.	The pound remains vulnerable to slower GDP, CPI and political uncertainty. We do not expect the BoE to hike rates until 2020. If a Brexit withdrawal agreement is reached by year-end, the pound should rally.

Source: Santander Economics, Rates and FX Strategy Research. For a full list of contributors, please see contact details on page 34.

Our main recommendations (and our the latest ones in here)

	USD	EUR	GBP
Govies	**Sell the 30y UST in ASW** Entry level = 18bp. Target level = 30bp. Stop loss = 12bp	**1) Buy SPGB 1.4% Jul-28 vs. Bund 0.25% Aug-2028** at +120bp. Target +70bp. **2) BTP-Bund 7y20y (2025-2037) box spread 'steepening'** at -1bp. Target +20bp.	**1) UKT 5s10s flattener (0T 23s/1F 28s).** Current level = 42bp. Target = 40bp. Stop Loss = 44bp. **2) Sell UKTI 28s on 85% beta-weighted BE.** Current level = 289bp, Target = 277bp. Stop Loss = 295bp.
Rates	**5s10s flatteners in swaps** Entry = 7bp. Target = 0bp. SL=10bp	**Pay 10y Euribor fixed, receive 10y ILS** at -0.58%. Target -0.45%	**Pay GBP 5y in a 2s510s fly..** Entry level = 3bp.Target = 7bp. Stop Loss = 0bp
FX	**Sell USD/CAD** originally at 1.3050 (31 August 2018) target= 1.27, with a stop loss at 1.3250	**Buy EUR/USD** at 1.1380. Target = 1.1700, with a stop loss = 1.1200.	**Buy GBP/AUD** at 1.80, target = 1.85, with a stop loss at 1.77

Global Strategy: Macro Slowdown and Safe Haven Flows

Antonio Villarroya
Head of G10 Macro & Strategy Research
(+34) 91 257-2244

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- **Despite the health of the global macro environment, it seems that the best days are behind us. This, together with multiple ongoing concerns, the end of QE (or actual tightening) and arguably still high valuations in some financial assets are causing significant safe-haven flows in the last quarter of the year.**

As recently highlighted by the IMF, global growth expectations continue to be marked down and this and next year's GDP growth is now forecast to be slower than expected three and six months ago. Most of the deceleration is seen to come from emerging markets, but advanced economies are also now expected to expand at a less robust pace than earlier this year. From Table 1 below, we would also highlight the sizeable downward revision in the largest euro countries' projected 2018 growth but also that basically no major economy is expected to accelerate next year. This is a similar conclusion to the one drawn by the OECD leading economic indicators (Chart 1).

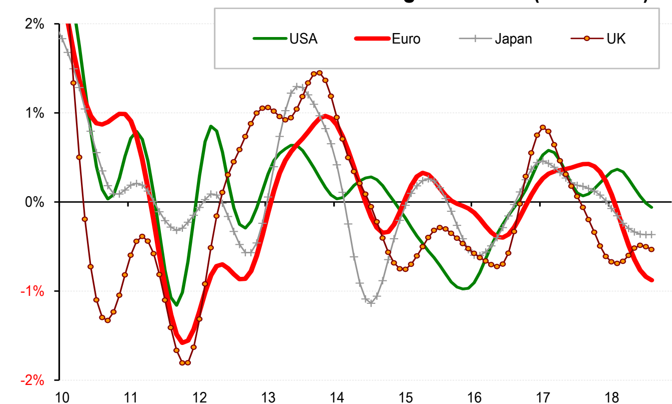
These concerns are obviously affected by the Fed's *dual tightening* (shrinking balance sheet and higher official rates) and the approaching end of the ECB's asset purchases, although this central bank is still far from raising rates (not before September 2019), and even further from shrinking its balance sheet, either via TLTRO redemptions (not before Jun'20) or through not reinvesting its portfolio redemptions (not for at least another two years).

Table 1: IMF GDP growth projections and changes vs. April,%

	GDP growth Expectation			Diff vs April 2018		Chg
	2017	2018	2019	2018	2019	19-'18
World	3.7	**3.7**	3.7	-0.2	-0.2	0.0
Advanced Econ	2.3	**2.4**	2.1	-0.1	-0.1	-0.3
US	2.2	**2.9**	2.5	-	-0.2	-0.4
Euro Area	2.4	**2.0**	1.9	-0.4	-0.1	-0.1
Germany	2.5	**1.9**	1.9	-0.6	-0.1	0.0
France	2.3	**1.6**	1.6	-0.5	-0.4	0.0
Italy	1.5	**1.2**	1.0	-0.3	-0.1	-0.2
Spain	3.0	**2.7**	2.2	-0.1	-	-0.5
Japan	1.7	**1.1**	0.9	-0.1	-	-0.2
UK	1.7	**1.4**	1.5	-0.2	-	0.1
Canada	3.0	**2.1**	2.0	-	-	-0.1
EM & Dev	4.7	**4.7**	4.7	-0.2	-0.4	0.0

Source: Santander, IMF

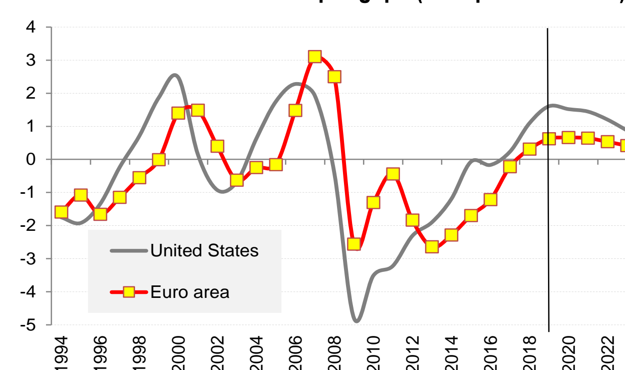
Chart 1: Advanced economies' leading indicators (6mth RoC)



Source: OECD

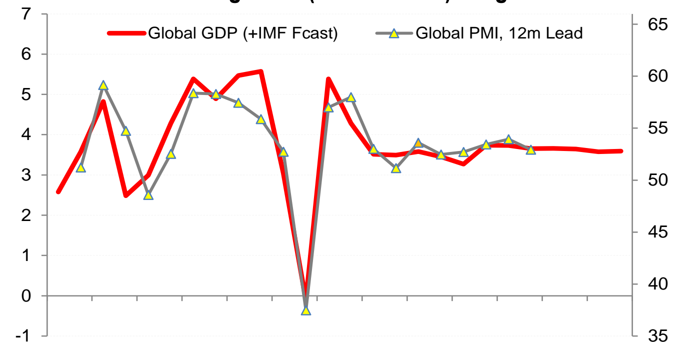
When looking at these long-term growth expectations, we would focus on: (1) **Rising output gaps**, but **for a limited time only:** the IMF, for instance, still sees the US and Euro economies growing above potential in 2018 and 2019, hence the widening output gap this year and next in Chart 2. But this above-potential growth is expected to start to – slowly - shrink from next year. (2) **Unstable stability**: we also find the extreme stability of the IMF's global growth projections interesting, at 3.27%-3.72% over 2012-2023 (Chart 3).

Chart 2: US and Euro area output gaps (% of potential GDP)



Source: Bloomberg, IMF, Santander

Chart 3: Global GDP growth (and forecast) vs. global PMI

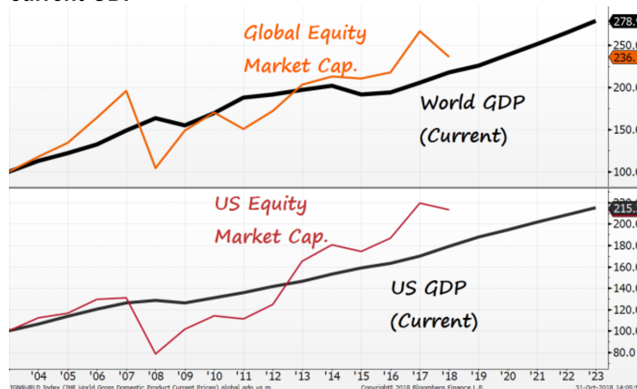


Source: Bloomberg, IMF, Santander

This macroeconomic environment is contributing to the recent market volatility, especially taking into account not only the arguably expensive valuation of many of these assets (at least according to historical standards) but also that 2019 will be the first year when the cumulative size of the largest central banks' balance sheets will start to shrink, and that will be combined with sizeable sovereign bond supply in some countries.

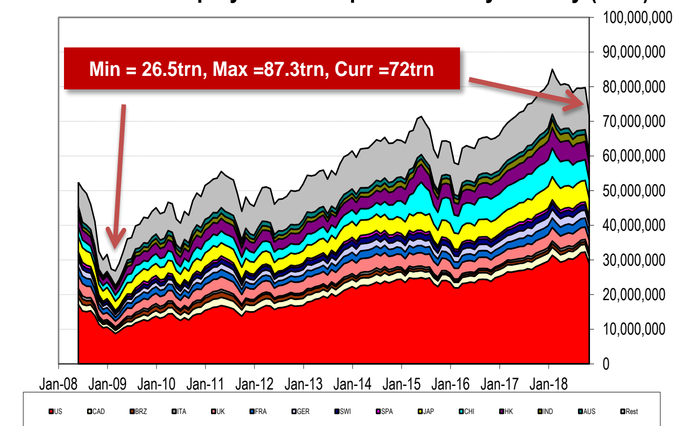
On the other hand, global liquidity remains ample and cheap (advanced economies' composite 3m Libor is c.87bp, and is expected to be below 110bp by the end of 2019). And it is worth highlighting that, although these high valuations and recent price action are raising some concerns, their performance in recent years also help to sustain the macro environment as, at the end of the day, equity market capitalisation has grown faster than these economies (Chart 4). And despite its recent [16%] decline, global equities' market cap is still $46trn above its 2009 low. Or up $23bn (+35%) vs. pre-Trump days (Chart 5).

Chart 4: Global and US equity market capitalisation vs. current GDP



Source: OECD, Santander

Chart 5: Global equity market capitalisation by country (USD)



Source: Bloomberg, Santander

But despite the fairly strong preliminary 3Q18 growth reading in the US (3.5% q/q saar), the market is likely to remain worried about the Fed's potential 'tightening into a slowdown' (Chart 6), especially in an environment where:

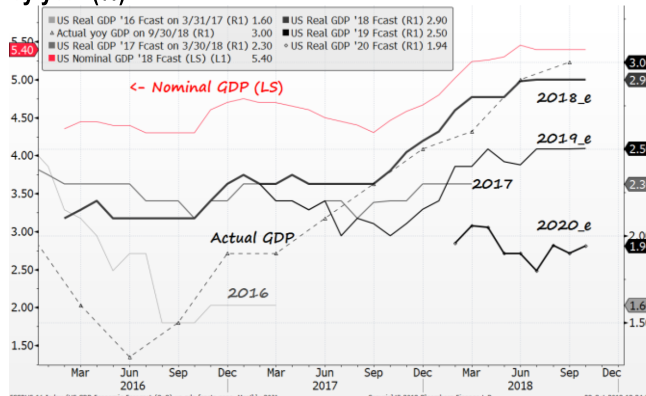
(a) the Fed is also reducing its balance sheet;

(b) high(er) yield levels in the US curve could prove to be an attractive safe haven opportunity in a highly volatile equity market (US 12m bills pay 60bp more than the S&P 500 dividend yield, which is flat YTD);

(c) the fiscal 'windfall' in US companies earnings, following the TC&JA stimulus, is starting to lose momentum, with US corporate profits probably coming closer to earnings going forward (Chart 7);

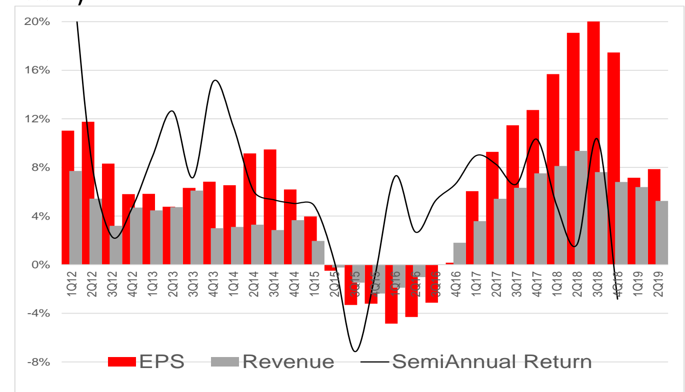
(d) high geopolitical uncertainty and trade war implications could cause a potential lose-lose situation for these economies.

Chart 6: US GDP growth; actual and consensus expectations by year (%)



Source: Bloomberg, Santander

Chart 7: S&P 500 earnings and revenue growth (+semi-annual return)



Source: Bloomberg, Santander

All these factors make the outcome of the upcoming **mid-term elections in the US** even more important, as a split House could have ramifications for further potential fiscal easing or infrastructure plans (ie, lack thereof), and the corresponding funding implications, in the second half of Trump's term.

We think this uncertainty will help to keep US Treasury yields from rising significantly in coming months, despite the tightening Fed and fast-rising bond supply, as safe-haven flows from riskier assets could well end up in this market in search of decent yield and lower risk.

Europe: a lengthy soft patch

(*) ".. it's simply that we're having growth returning to potential after 2017, where it was clearly above potential."
Mario Draghi, ECB meeting press conference, 24 October 2018

In the Euro area, despite the looser financial conditions - with no indications that this environment is likely to change in the near future – the macro situation remains far from rosy, which the unstable political backdrop does little to help.

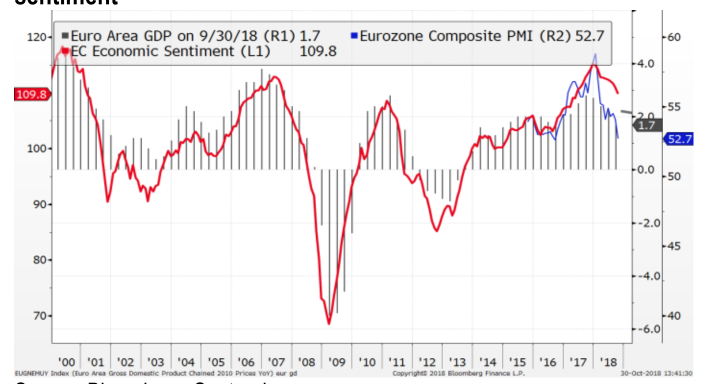
To the above-mentioned downward revisions in Euro area countries' growth by most forecasters, we would need to add the recent weaker-than-expected Euro area PMI numbers and the – still preliminary and short on detail – poor 3Q18 growth figure.

The question is then whether the recent slowdown is merely an unwinding of the very strong economic performance seen at the end of 2017, as economic sentiment indices seem to suggest (Chart 8), and which appears to be Draghi's positioning (* see margin). Or whether the sharp deceleration witnessed in this preliminary GDP figure, or in the October PMIs, is a sign of a more profound and lengthy deceleration (Chart 9).

Chart 8: Euro area economic sentiment by Countries

Source: Bloomberg, Santander

Chart 9: Euro area GDP growth, Composite PMI and economic sentiment



Source: Bloomberg, Santander

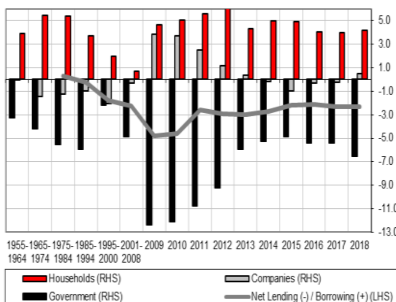
At this stage, we are closer to the position of the ECB's president, and continue to believe that the official rates normalisation will probably start in September 2019 as despite the low rates of growth expected, a healthy labour market, accelerating wage settlements, core inflation close to target and an economy growing – at least - around potential (see EUR Economics section) should be enough to convince the ECB Governing Council to start taking its official rates to 'more normal' levels at some point. And having short-term interbank rates below zero (E3m = -32bp and 1y1y EONIA at -14bp), as they currently trade, cannot be considered normal.

US Economic Outlook

Antonio Espasa
(+34) 91 289 3313

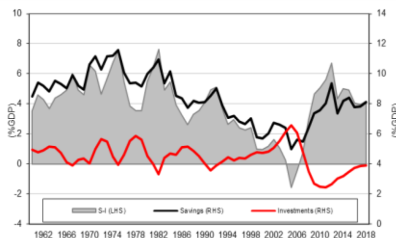
GDP growth has been positive in recent quarters, clearly supported by Mr Trump's fiscal package. However, although the money "received" by households and companies from the government has had a positive impact so far, we find that not all of it has been invested/spent. So far, part of that money seems to have helped both households and companies to improve their financing gap but, on the other hand, that of the public sector has deteriorated. In our view, higher investments and ultimately increased productivity growth rates could be key to keeping the economy growing above potential. That would help to adjust the public sector financing position and allow this fiscal package to be called a success.

Chart 10: US net lending / borrowing by sector, 1955-2Q18



Source: Datastream and Santander.

Chart 11: US households' net lending / borrowing, 1960-2Q18



Source: Datastream and Santander.

Transferring money from the public to the private sector

US GDP growth has been very positive in recent quarters, with annual growth rates moving above the 2.5% level again since 4Q17 and reaching 2.9% in 2Q18. The fiscal package launched by Trump's government will certainly have had a positive effect on those numbers since the beginning of the year. The government "support" for both households and companies has had a positive impact so far on consumption and investments. However, it is also true that neither households nor companies have spent all the money received, as their net lending/borrowing positions reflect. On the other hand, the net lending/borrowing position of the government has clearly shown a deterioration since the beginning of the year.

The better net lending/borrowing position of the private sector since the beginning of the year (4.72% of GDP in 1H18 from 3.7% of GDP in 2017) could therefore be attributed to the "transfers" received from the government (-6.54% of GDP in 1H18 from -5.4% of GDP in 2017) rather than to firm decisions about managing their savings and/or investments. The opposite situation applies to the public sector. In the end, the overall economy has so far maintained the same net borrowing position (-1.8% of GDP in 1H18 versus -1.7% of GDP in 2017).

The success of the fiscal package is obviously linked to the future performance of the economy, i.e. whether the better financing position of the private sector, at the cost of a more negative position of the public sector, ends up pushing GDP growth rates higher and those higher growth rates help the government to improve its negative position. At the end of the day, we believe that the answer could lie in productivity. We recall that some of the measures included in the fiscal budget aimed to support business investments in order to improve productivity. If productivity growth rates accelerate and start to consistently exceed those seen in recent years, economic growth is likely to move above 2.5% and the adjustment of the public sector accounts would be easier.

Households' financing gap improved to 4.2% of GDP in 1H18 from 4.0% of GDP in 2017

Households' net lending position improved in 1H18. It rose to 4.19% of GDP from 3.96% of GDP in 2017, representing the biggest surplus since the 4.92% reached in 2015. Here, the most interesting question, apart from the improvement in the net lending position, is the breakdown of that improvement, i.e. has the improvement come from the savings side or from the investment side? That would give us an idea of whether or not there has been a change in consumers' attitudes to consumption and saving.

The net lending position of households break downs into: (1) a savings position of 8.1% of GDP ($1.640tr) in 1H18 from 7.8% of GDP ($1.526tr) in 2017; and (2) an investment position of 3.9% of GDP ($793bn) in 1H18 vs. 3.9% of GDP ($755bn) in 2017. That is, households have not used all the "extra income" received to raise consumption or increase investments.

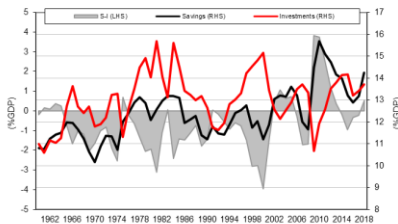
- Personal income has basically maintained the same growth rate since the beginning of the year (median of 0.3% MoM since the beginning of the year, with an increase of 0.5% MoM in January).
- Personal disposable income has also been relatively stable since the beginning of the year (median of 0.4% MoM) but posted a sharp increase of 1.0% MoM in January, courtesy of a decline of 2.8% MoM in taxes paid.
- However, when we look at consumption, we find that personal outlays

rose by just 0.2% MoM in January and actually fell by 0.1% MoM in February, which resulted in a sharp increase in savings. Real personal consumption numbers were negative in both months.

- Savings rose by $120bn in January to total $1.060tr, with the savings rate (% of GDI) up sharply in the month (7.0% in January 2018 from 6.2% in December). Moreover, the savings rate rose again in February (7.4% of GDI and $1.124tr).
- Looking at the recent performance of the residential sector, it does not seem that household investments in real estate are likely to surprise on the upside in 3Q18E. As a result, the current borrowing/lending position of households might remain stable in 3Q18E.

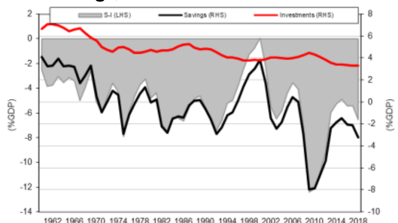
In the end, the fiscal package could have proved useful merely to improve the balance sheet of households in the short run, with probably a lower impact than initially expected on economic growth.

Chart 12: US companies' net lending / borrowing,-, 1960-2Q18



Source: Datastream and Santander.

Chart 13: US government net lending / borrowing-, 1960-2Q18



Source: Datastream and Santander.

Companies' financing gap improved to 0.5% of GDP in 1H18 from -0.2% of GDP in 2017

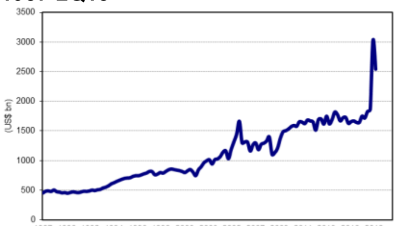
The net lending/borrowing position of companies also improved in 1H18. After running a negative borrowing position since 2014, they turned positive in 1H18. The positive 0.5% of GDP reached so far this year breaks down into: (1) an increase in the savings position to 14.2% of GDP ($2.880tr) from 13.2% of GDP ($2.569tr) in 2017; and (2) a more modest increase in investments to 13.7% of GDP ($2.773tr) from 13.4% of GDP ($2.613tr) in 2017. Again, like households, companies have not spent/invested all the money they have received through taxes.

- Profits before tax of non-farm non-financial corporations rose by 2.8% QoQ in 1Q18 and by 7.2% QoQ in 2Q18.
- However, internal funds (book profits) rose by a sharp 62.6% QoQ in 1Q18 (-16.0% QoQ in 2Q18). A cut in taxes on corporate income of 33.1% QoQ in 1Q18 from a decline also of 12.4% QoQ in 4Q17, plus a sharp adjustment in capital consumption (15.7% QoQ in 4Q17) and a fall in net dividends (-$326bn) in 1Q18 would be behind that significant improvement.
- Finally, foreign earnings retained abroad also reacted to the new fiscal measures by falling by $690.2bn in 1Q18 and by $207bn in 2Q18. In the end, all these fiscal-driven "adjustments" pushed total internal funds (+inventory valuation adjustment) down by 39.5% QoQ in 4Q17 and up by 82.6% QoQ in 1Q18.
- However, fixed investments did not grow accordingly, since they moved up by 3.2% QoQ in 1Q18 and by 2.5% QoQ in 2Q18.

Chart 14: US non-farm non-financial corporations, corporate taxes, 1987-2Q18

Source: Datastream and Santander.

Chart 15: US non-farm non-financial corporations, internal funds (book), 1987-2Q18



Source: Datastream and Santander.

Real GDP-fixed investments showed an increase of 1.9% QoQ in 1Q18 and 1.6% QoQ in 2Q18. The figure is likely to go up also in 3Q18E, although 4Q18E numbers could start to weaken, in our view.

Productivity growth rates still too low by historical standards…

Although we should probably wait a few more quarters to see the real effect that these fiscal measures have had on productivity growth rates, the reality so far is that current growth rates have not seen a great improvement (1.2% in 1H18 vs 1.1% in 2017). We recall that productivity grew on average by 2.6% in the period 2000-07, just before the crisis started. Moving averages for both 5-year and 10-year productivity growth rates (see Chart 16) show how low productivity growth rates currently are.

Chart 16: US productivity, 1960-2Q18

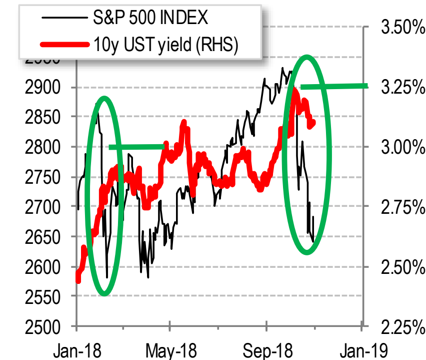
Source: Datastream and Santander.

US Rates Strategy: 3.25% is the new 3%

José María Fernández
(+34) 91 257 2244

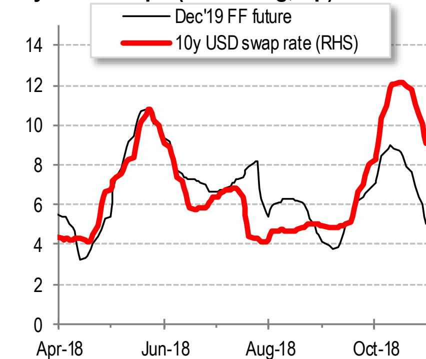
- **Recent volatility confirms, in our view, that the road to higher yields in the US curve proves bumpy when changes happen too fast. Therefore, while we continue to think that we will see higher rates in coming quarters, the risk of sharp sell-offs persists, albeit contained. Interestingly, while this volatility has not caused a sizable change in monetary policy expectations (with the market pretty much in line with our expectations), it has had an impact on real rates. We are closing with profits our shorts on 2y real rates, recommended last month. We continue to see value in 5s10s flatteners.**

Chart 17: YtD evolution of 10y UST yields and S&P 500



Source: Bloomberg, Santander.

Chart 18: Standard deviation in FFZ9 and 10y USD swaps (3m rolling, bp)



Source: Bloomberg, Santander.

Recent volatility has not had a material impact on monetary policy expectations…

Since the previous edition of this report, US rates have proved quite volatile. The 10y UST, which had been hovering around the 3% mark but was unable to trade through May highs, finally broke those levels and set a new year-high at c.3.24% on 5 October. However, as in January when 10y rates threatened to break through the 3% mark for the first time in over four years, market fears surged about US rates moving too high, too fast, and US equities dropped 10% in just a few sessions (see Chart 17).

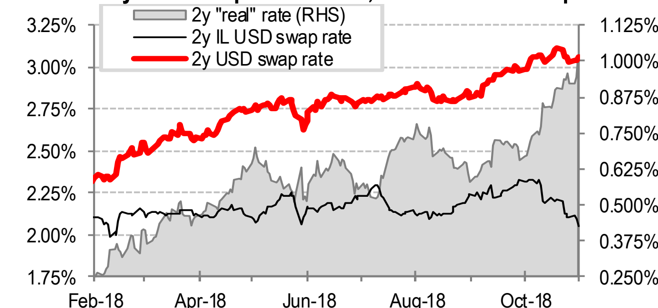
We see this market behaviour as confirmation of our expectations that, at these levels, US rates will try to trade gradually higher in coming months, but any acceleration in the upward move will depend on potential renewed fears of overvaluation in other assets. Therefore, any sudden sell-offs in USTs are likely to continue to be followed by sell-offs in risk assets, in turn increasing the appetite for USTs as part of the safe-haven bid.

We also note that the very front end of the US curve has apparently been largely immune to this market volatility, so monetary policy expectations have proved very stable after the sudden repricing we mentioned in the previous edition of this report. As shown in Chart 18, the market seems to have become comfortable with its expectations that the Fed, despite the message implied by the FOMC dots, will need further evidence of an overheating economy prior to hiking rates beyond neutral levels (and this therefore looks very unlikely, in our view).

….but it has affected real rates. Closing with profits our tactical short on 2y US "real" swap rates

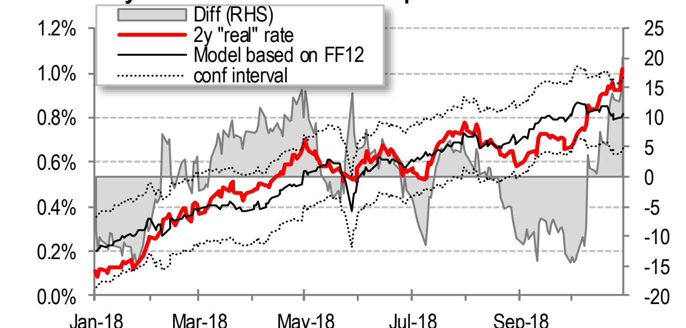
Interestingly, while nominal rates had paid a round-trip ticket to the 3.25% area, real rates joined nominal rates during the sell-off but failed to correct back during the nominal rally (possibly affected by the sudden decline in oil prices) and, as a result, "real" rates are 30bp above last month (Chart 19).

Chart 19: 2y USD swaps – nominal, IL and "real" components



Source: Bloomberg, Santander.

Chart 20: 2y "real" rates – the catch-up has occurred



Source: Bloomberg, Santander.

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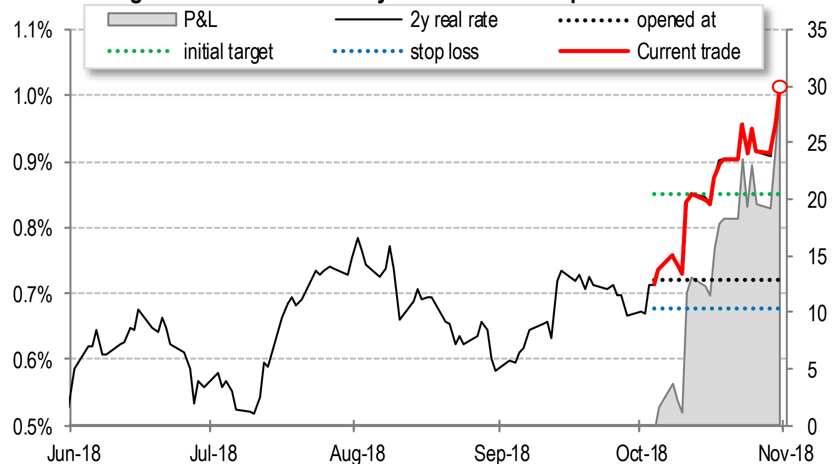
This increase in "real" rates is fully in line with the correction we were expecting in this asset last month, when we recommended paying the 2y USD swap rate vs. the 2y IL swap rate. As shown in Chart 20, we made this recommendation when the 2y "real" rate traded through the lower end of the confidence interval suggested by our model, and in these four weeks the 2y real rate has reached the higher end of our model's confidence interval. Therefore, we see no additional potential in this trade, as the dislocation has disappeared, and opt to close the trade with profits.

Close trade idea: Pay fixed in 2y USD swaps vs. 2y IL swaps

Entry level = 0.72%. Initial target = 0.85%. Current level = 1.01%.

Chart 21: Closing our tactical short on 2y "real" rates with profits

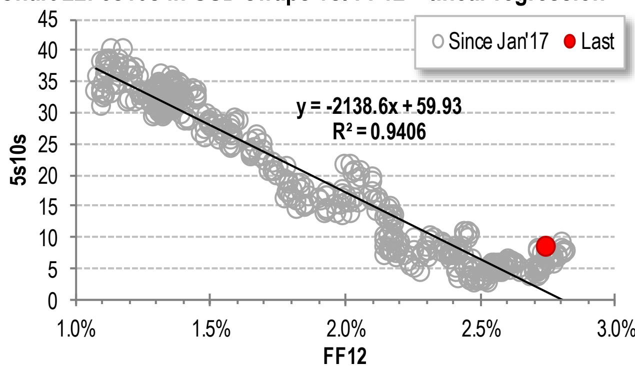


Source: Bloomberg, Santander.

We reaffirm our positioning in 5s10s flatteners

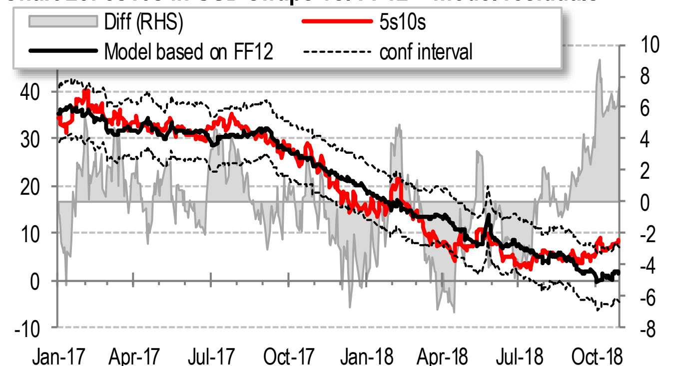
As for the rest of the year, we continue to see value in 5s10s flatteners. We opened this trade last month, when the slope was trading at 7bp, and it is currently 1bp steeper now. As shown in Charts 22 and 23, we continue to think that as the Fed continues with its normalisation process (and another 25bp hike is expected to be delivered in December), the US curve should continue to flatten – with 5s10s showing a R2 = 94.1% vs. the FF12 contract since January 2017. We continue to target a 0bp slope, as suggested by our model

Chart 22: 5s10s in USD swaps vs. FF12 – linear regression



Source: Bloomberg, Santander.

Chart 23: 5s10s in USD swaps vs. FF12 – model residuals



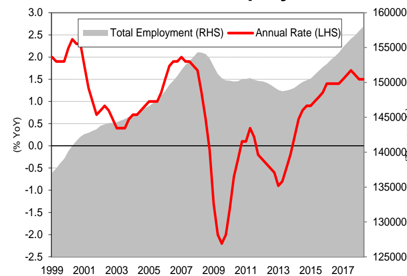
Source: Bloomberg, Santander.

Eurozone Economic Outlook

Laura Velasco
(+34) 91 175 2289

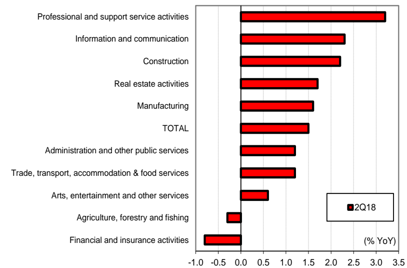
Job creation continues at a solid pace in the Eurozone, amid an improvement in indicators on the quality of the recovery in the labour market. In our view, this points to a clearer upswing in salaries to sustain households' income and sentiment.

Chart 24: Eurozone employment



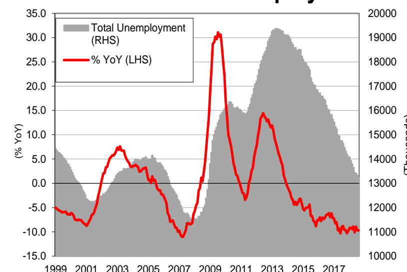
Source: Eurostat, Santander.

Chart 25: Eurozone employees by sector



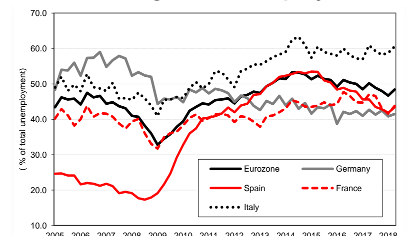
Source: Eurostat, Santander

Chart 26: Eurozone unemployment



Source: Eurostat, Santander.

Chart 27: Long-term unemployment



Source: Eurostat, Santander.

The labour market continues to support private consumption and household confidence in the Eurozone, where the solid pace of job creation continues to favour further declines in unemployment. We believe we are in a new phase of recovery that should bring a clearer upswing in salaries.

Employment figures still very encouraging…

Since 2013, employment in the Eurozone has recovered sharply, a recovery that, far from moderating, continues apace, showing very encouraging figures that led to a new record high of 158 million people in employment in the Euro area in 2Q18, thanks to keeping up an annual growth rate of close to 1.5%. Importantly, this upward trend in employment is solidly supported by the vast majority of productive activities, with the only exceptions being agriculture (at -0.3% YoY in 2Q18) and financial & insurance activities (-0.8% YoY). We note the strong pace of job creation in professional & support service activities (at 3.2% YoY in 2Q18), information & communication (2.3% YoY) and construction (2.2% YoY).

As expected, these favourable trends in employment are having a very positive influence on unemployment figures. According to Eurostat, total unemployment dipped 9.7% YoY in August to return to a similar level as those seen in 2007. The unemployment rate stood at 8.1% in August, the lowest rate on record since the end of 2008 and down from the peak of 12.1% seen at the beginning of 2013.

Furthermore, judging by business confidence surveys, companies in the area still have very good expectations about their future staffing levels. Notably, the outlook for employment in services, industry and construction remains between one and two standard deviations above their historical average, i.e. pointing to the maintenance of a sound pace of expansion in employment in the main productive sectors.

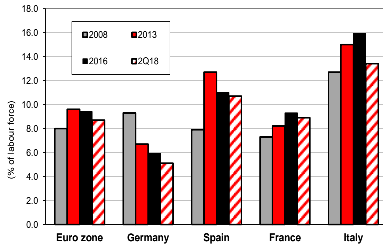
…as are other relevant labour market indicators…

Admittedly, a great effort is needed to reduce long-term unemployment (people seeking work for twelve months or more) in the area. For the Eurozone as a whole, long-term unemployment reached a peak of 52.8% of total unemployment in 2014, subsequently falling but still accounting for nearly 49% of total unemployment in 2Q18. The discrepancies among countries are quite significant; we would highlight the progress in Spain (in clear contrast to Italy) but, all in all, we believe that the generally positive dynamics in employment creation among nations should drive a further improvement in these ratios.

Indeed, the positive scenario for employment has consolidated in the Eurozone, with a very encouraging outlook for the coming quarters. In our view, several indicators suggest that progress is also being made as regards the quality of the labour market upturn, e.g. the degree of underutilisation* of the labour factor in the economies. For this analysis, we focus on data for those who are not included in the active population under the conventional definition but that, in our view, can be very useful as a proxy for the labour market "slack". We have analysed the evolution of persons available to work but not seeking a job, persons seeking work but not immediately available and underemployed part-time workers. We thus obtain a broader definition of the unemployment rate that, as can be seen in the chart on the next page, is also declining for the Eurozone as a whole, to 8.7% in 2Q18 from a peak of 9.6% in 2013.

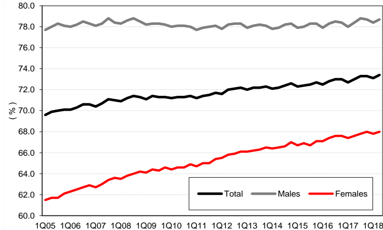
Furthermore, data about transitions in the labour market also confirm what may be inferred from the tone of both employment and unemployment. That

Chart 28: Labour underutilisation*



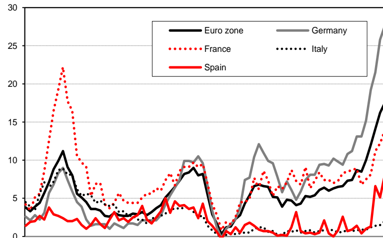
Source: Eurostat, Santander.

Chart 29: Eurozone participation rate



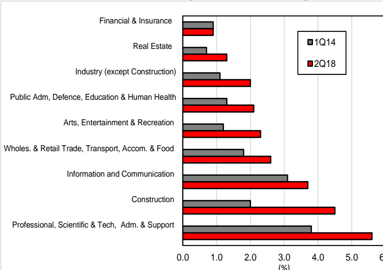
Source: Eurostat, Santander.

Chart 30: Labour as a factor limiting production



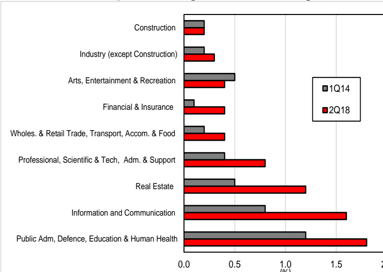
Source: EC, Santander.

Chart 31: German job vacancy rate**



Source: Eurostat, Santander.

Chart 32: Spanish job vacancy rate**



Source: Eurostat, Santander.

is, flows figures suggest that there is a clear rise in the likelihood of finding a job or changing from an inactive status to again participating in the labour market, as well as a fall in the probability of losing employment.

At the end of the day, there seems to have been a clear upturn in the Eurozone participation rate to a total of 73.4% in 2Q18, which is mainly explained by the rebound in the participation rate among women to 68.0% (at 78.7% among men) and for good reason, given that the employment rate among women has also risen to 62.1% in 2Q18 from 57.8% in 1Q13.

Moreover, we believe that the signals for the labour market in the coming quarters suggest a continuation of these positive trends. Despite the degree of maturity of these trends, companies still face problems with their current installed capacity and need to continue increasing their staffing levels. Germany was leading this trend, but it is now progressively extending to other economies such as Spain and France.

In our view, it is also very significant that, after nearly four years of positive employment creation and having reached a record high, the number of vacancies continues increasing and even accelerating somewhat. For the Eurozone as a whole, the vacancy rate** (defined as the percentage of vacancies with respect to total occupied posts plus vacancies) was at 2.1% in 2Q18 compared to 1.9% in 2Q17, driven by both industry and construction at 1.9% (from 1.6%) and services at 2.4% (from 2.3%). Among the major countries in the area, again, the case of Germany is particularly noteworthy. The vacancy rate in the German professional, scientific & technical, administration & support activities, for example, was at 5.6% in 2Q18 but, in general, the predominant trend in vacancy rates among activities in Germany, France, Italy and Spain is supportive for the formation of tensions between supply and demand of labour in some segments.

…increasing upward risks for salaries

According to the European Commission's confidence surveys, consumer optimism has retreated and households are beginning to be concerned about the rise in prices that, together with a certain worsening in unemployment expectations, could negatively affect their financial situation in the next twelve months. In our opinion, this is a factor to monitor closely because of the important role that private consumption plays in total GDP growth, although we believe it should not be a problem. First of all, because the decline in household sentiment comes in the wake of the spectacular rebound seen in 2017, and it remains at around its highest reading since 2007 and 1.7 standard deviations above its historical average.

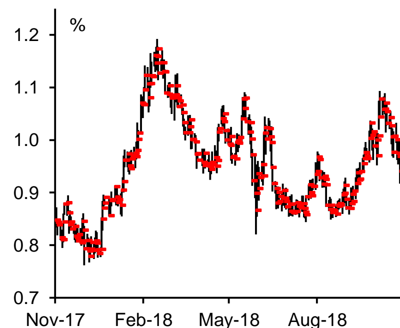
Secondly, readings from the labour market suggest that employment creation should remain healthy and, at the same time, there are increasing signs of a more evident contribution from salaries to household income. According to Eurostat, hourly labour costs in the business economy rose by 2.4% YoY in the Eurozone in 2Q18 (from 2.3% YoY in 1Q18 and an average of 1.9% in the full 2017), including wages & salaries per hour worked at 2.2% YoY in 2Q18 and the non-wage component at 3.1% YoY. In specific sectors, total hourly labour costs grew by 2.2% YoY in industry, 2.7% YoY in construction and 2.5% YoY in services. Judging by the tone of the aforementioned indicators, we believe that this upward trend in wages could be consolidated in the coming quarters, which would be very good news as it would shore up households' confidence and purchasing power against a background of rising oil prices.

Euro Rates Strategy: Risk-off sentiment returns but core rates are still too low

Luca Jellinek
(+44) 33 114 80133

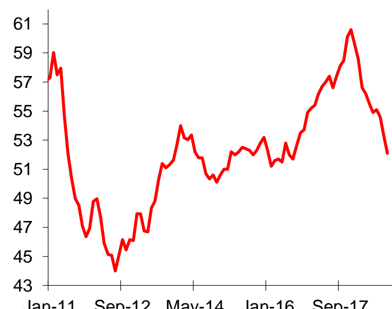
- **The process of policy and interest rate 'normalisation' was never going to be smooth and losses in equities are just one symptom. As in the US before, the Euro area market probably underestimates how much rates will rise in the future.**
- **Stresses in Italian debt are unlikely to result in a full-blown crisis but we remain underweight. Conversely, SPGBs are underpinned by solid economic results and we would be overweight.**

Chart 33: Euribor 10y rate



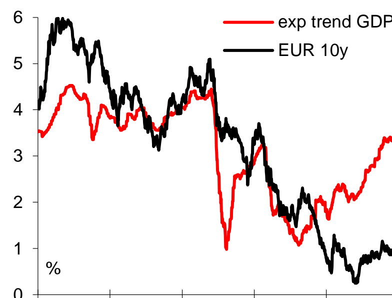
Source: Bloomberg, Santander

Chart 34: Euro area manuf. PMI



Source: Reuters Markit, Santander

Chart 35: EUR rates still quite low even relative to so-so economy



Source: Eurostat, Bloomberg, Santander

Another rise in EUR rates is faded by the market

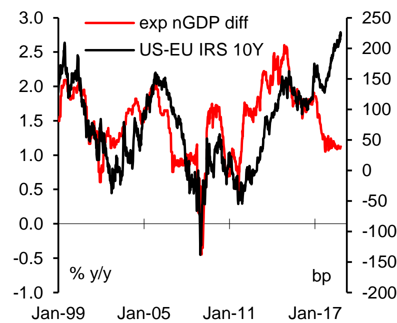
Not for the first time, a **bearish phase in EUR rates has ended up disappointing expectations** of a straightforward, protracted rise in rates. From late August to early October, the 10y Euribor rate ground 22bp higher. It has since retraced lower by 15bp and it never really broke through the May relative highs, let alone test the February levels. In other words, **upside rate momentum still looks distinctly soft**. The bullish correction in EUR rates is attributable, in our opinion, to three main factors, in descending order of importance:

- Rather broad-based concerns about the durability of global expansion and financial stability in the face of heightened trade tensions and high asset valuations. A symptom of such concerns is the recent **sharp slide in equity prices**, which have apparently brushed aside a pretty solid start of the earnings season.
- Within the Euro area, volatile sovereign risk premia, driven by the **face-off between the Italian government and the EC over fiscal policy loosening** has on many occasions coincided with risk-off rallies in Bunds.
- From the rather euphoric state in late 2017, the Euro area economy has been gradually drifting closer to its rather modest potential growth pace. **Real y/y GDP growth has decelerated** by ¾ of a percentage point since 2017 and the manufacturing PMI figure is 8.5 points below its relative highs, at the last reading. At the same time, underlying inflation remains quite contained, at around the 1% mark.

Having said all that, the tentative nature of the rise in rates does not preclude further increases in coming months, albeit in the familiar stop-and-start manner.

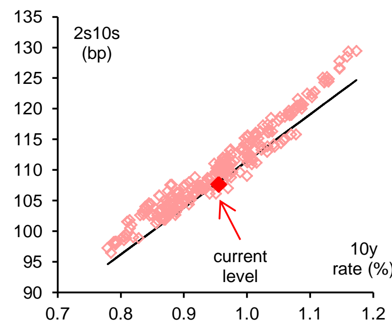
- Volatility in equity and lower-rated fixed income markets are arguably a consequence of the main central banks attempting to deflate asset market valuation 'bubbles' fomented by years of QE/ZIRP. Such a process implies higher policy as well as term rates. As we recently noted in a separate research note, the record of the US market suggests that **investors might underestimate the ultimate impact on rates of the monetary policy normalisation process** and we believe that a similar condition prevails in the Euro area rates market.
- Even if the mix of real growth and inflation produces sideways nominal growth figures going forward, the super-loose policy environment has kept market rates well below where they might be given current macro conditions. In other words, there are many **tens of bp of 'catching up' for market rates before they are anywhere close to some semblance of fair value**.

Chart 36: EUR rates very low relative to USD rate



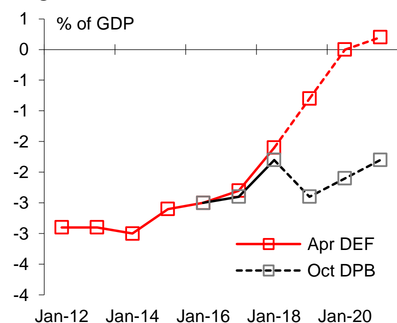
Source: BEA, Eurostat, Bloomberg, Santander

Chart 37: EUR 2s10s slope vs. direction (with lower bands showing 3m carry relative to 'fair value')



Source: Bloomberg, Santander

Chart 38: Change in Italian deficit targets



Source: Eurostat, MEF, Santander

Wait for better timing to re-build short positions

Considering positioning in relation to the current 'shallow bearish' environment, we have tended to emphasise the carry aspect of trades, given the slow pace of the sell-off, as measured from the late 2016 all-time EUR rate lows.

In outright terms, we had a '**short real 10y EUR rates**' position on through summer, and in mid-October, relatively near to the highs, **we recommended reducing it**. The rate is currently -60bp. If the ongoing correction carries that to -70bp or lower, we would add again to that position, but for now reduced exposure makes sense, we think.

The USD-EUR spread is at historically extreme levels; well in excess of what the macroeconomic and even policy divergence would suggest. We made this point back in September but USD-EUR rates spreads are *wider still*. The main problem with an outright tightening trade is the relatively high carry cost, in excess of 1bp/month for intermediate tenors.

Term structure behaviour has been quite systematic, from a statistical standpoint, in recent months. **The middle of the curve remains the most volatile set of tenors** so that, when rates rise, 5s and 10s steepen relative to 2s and 3s while they tend to flatten relative to 15s and 30s. As we draw nearer to the first ECB rate hike, foreseeably in the second half of 2019, the curve-direction regime should shift to bearish flattening / bullish-steepening, although that is not likely to be the case in coming weeks or even months. At present, there are no outstanding anomalies along the term structure and the 'directional' curve trades (like 10s30s flattening or 2s10s steepening) tend to have negative carry, which makes them less attractive. **The 5s30s flattener is about 6bp in the money and we would close it now**. Our remaining current directional / macro positions are as follows:

Trade idea: 'Synthetic' €-hedged, US-backed assets

ASW UST 2.875% May-2028 & XCS into € vs. RASW Bund 0 5% Feb-2028. This trade is close to the initial entry level at a pick-up of 31bp.

Higher 10y real rates (reduced position)

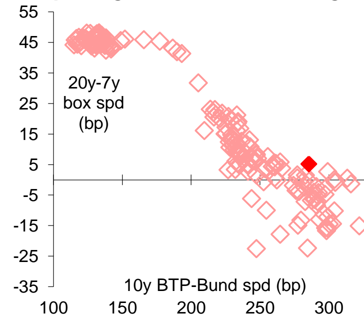
Pay 10y Euribor IRS and receive 10y ILS (EMU ex-tob. HICP). The real 10y Euribor rate has risen to -0.60% and we target -0.45%.

Long, short or neutral Italy?

Volatility in Italian sovereign risk spreads remains quite elevated, with double-digit changes in spread (in bp terms) from one session to the next far from rare. Investors are still reacting sharply to news flow from the Italian government and its **ongoing differences with the European Commission over near-term fiscal policy decisions**. The latest state of play is that the EC has formally rejected the figures provided by Italy and the latter so far has remained committed to the larger deficit figures it submitted.

Although tensions are running high, **we think that the conflict over the 2019 budget will not lead directly to a funding crisis**. Tough statements by both sides tend to be followed by more conciliatory talk and past Euro area history suggests that a minor set of adjustments can result in a compromise being reached, allowing both sides to claim 'victory'. Furthermore, the appetite for a messy Italian sovereign debt crisis among Euro area institutions and member governments is presumably low. Lastly, even if current differences are not reconciled, the application of an excessive deficit procedure would be relatively protracted in time and typically not very burdensome, per se.

Chart 39: 20y-7y box spread steepening vs. BTP-Bund outright



Source: Bloomberg, Santander

Barring a very considerable deterioration in primary market liquidity or more concrete signs that Euro area institutions are willing to countenance a debt crisis, the sort of spreads paid by Italian paper even in short maturities (such as 3y at over 220bp above OBL yields) seem attractive.

However, as the rating agencies now re-examining Italy's creditworthiness have pointed out, **the longer-term debt sustainability of Italy is unlikely to be reinforced by less business-friendly and less fiscally prudent policies**. Moody's recently downgraded Italy and S&P, which had upgraded their rating last year, changed the outlook to negative at the end of last week. There are no officially scheduled Italy reviews from the four ECB-recognised rating agencies for the remainder of the year but that is not really the point.

Overall, we maintain **our view that EGB-benchmarked investors should be underweight or at best neutral Italy**. Within that overall stance, we believe that **BTPs out to 7-8y are comparatively good value while everything beyond 10y is poorer relative value**. In terms of tracking these views, we stick with a trade that has moved well into the money[1].

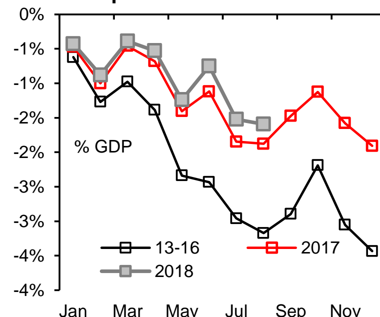
Trade idea: BTP-Bund 7y – 20y box spread 'steepening'

Sell: BTP 4% Feb-2037 & Bund 1% Aug-2025
Buy: BTP 1.45% May-2025 & Bund 4% Jan-2037

We recommended this at -12bp and the current box spread is +6bp. We target just above the recent range, at +20bp. The carry is positive (roughly 1bp per month).

The alternative to volatile BTPs isn't rich Bunds, it's the 'deserving periphery'

Chart 40: Spain deficit / GDP shows further improvement



Source: IGAE, Santander

As we noted in the document in the footnote below, it cannot be denied that some degree of contagion still exists between BTP spreads and the sovereign risk measures of other periphery issuers. This reflects both ingrained habit as well as increased focus on economic policy risk, so that any signs of less growth- and debt stabilisation-friendly policy attract greater attention than they would otherwise. See for instance the rather modest budget loosening proposals in Spain (assuming they can even be approved by parliament).

The crucial fact, however, is that Portugal and Spain (and to some extent, Greece) are performing quite differently from Italy. Output and employment growth remains quite robust, despite the deceleration across the Euro area, meaning that budget results look encouraging. Rating agencies have delivered upgrades for Spain, Portugal and Greece this year and are likely to do so again next year. Among that set, Spain is the largest, most liquid and by far lowest debt/GDP issuer. We think it makes sense for investors to remain overweight SPGBs, rather than German paper which still pays negative real yields.

Trade idea: SPGB outperformance

Sell: Bund 0.25% Aug-2028
Buy: SPGB 1.4% Jul-2028

The current spread is 115bp. We target 70bp. The carry is positive (around 1bp per month).

[1] See: "Periphery EGB exposure: stay long SPGBs and in the BTP box steepener".

Euro government bond supply: YTD update

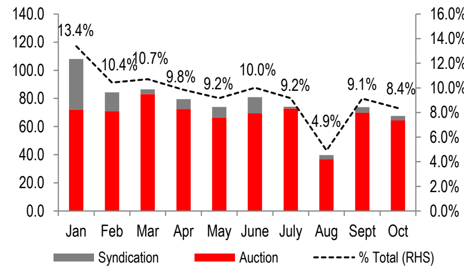
Edgar da Silva
(+34) 91 257 22 44

Slight change in the Spanish issuance target

According to the Kingdom of Spain's latest presentation, dated 3 October, the Tesoro has modified Spain's gross financing needs for the second time this year (to amortise more ESM debt), but has left net funding unchanged at €40bn. As a result, in medium- and long-term debt, expected redemptions have increased by €3bn to €89.3bn, taking the target for gross issuance of SPGBs and linkers to €134.3bn (vs. the €131.3bn set in June and €8bn above the target set in Spain's funding plan at the beginning of the year).

Considering the changes in Spain (from €131.3bn to €134.3bn), we now estimate a combined Eurozone 2018 issuance requirement equivalent to €808bn (€805bn at the beginning of the month.

Chart 41: Monthly EZ supply – YtD *(€bn)*



Source: Bloomberg, Santander

Euro area govie issuance at 95% completion with two months to go until the end the year

Up to the end of October, EUR issuers had sold more than €768bn worth of bonds via both ordinary auctions (close to €678.1bn) and syndicated deals (€90.5bn), representing an average of 95% of their combined and now revised 2018 issuance target (c.€808bn).

In terms of YTD completion rates by country, all the Eurozone issuers, bar Finland, have surpassed the 85% mark. Ireland (104%), France and Portugal (tied at 103%) have already issued more than initially planned for 2018, with still two months to go to the end of the year. The next issuers in line to reach the 100% mark are the Netherlands, Belgium, and Italy, which have already covered 98%, 98% and 96% of their 2018 targets, respectively. Then we have Spain (90%), Germany (88%) and Austria (85%), while Finland (at 82%) is making gradual progress towards completion (see Table 2).

Table 2: Total issued in EZ in 2018, by country (updated as at 31 October)

	GE	FR	NE	AS	SP	BE	PO	IT	IR	FI	TOTAL EZ (€bn)
YtD auctioned issuance	128.0	193.1	22.6	11.0	93.2	20.9	7.5	193.0	5.7	3.0	678.1
YtD syndicated issuance	0.0	7.5	0.0	4.8	27.0	9.5	8.0	16.7	11.0	6.0	90.5
YtD Issuance	128.0	200.6	22.6	15.8	120.2	30.4	15.5	209.7	16.7	9.0	768.5
2018 programme	145.0	195.0	23.0	18.5	134.3	31.0	15.1	219.0	16.0	11.0	807.9
% completion (RHS)	88%	103%	98%	85%	90%	98%	103%	96%	104%	82%	95%

Source: Bloomberg , Santander

Table 3: YTD issuance completion vs. historical data

	2013	2014	2015	2016	2017	2018	Aver 13-17
GE	87%	88%	90%	89%	89%	**88%**	89%
FR	90%	88%	90%	90%	90%	**103%**	89%
NE	91%	93%	91%	91%	91%	**98%**	91%
AS	85%	91%	87%	95%	95%	**85%**	91%
SP	88%	89%	91%	89%	87%	**90%**	89%
BE	100%	94%	93%	93%	100%	**98%**	96%
PO	100%	93%	94%	96%	91%	**103%**	95%
IT	83%	91%	91%	89%	89%	**96%**	88%
IR	100%	68%	100%	91%	92%	**104%**	90%
FI	100%	97%	96%	93%	93%	**82%**	96%
TOTAL EZ (€)	**88%**	**90%**	**91%**	**90%**	**90%**	**95%**	**89%**

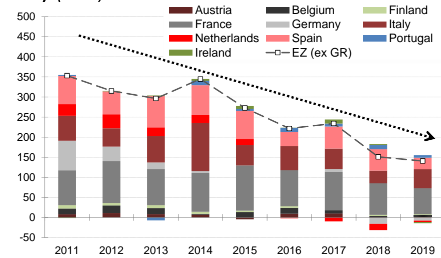
Source: Bloomberg, Santander. YtD (calendar year) data for 2018. Jan-Oct aggregates for historical data.

EUR supply: 2019 preview

As we approach year-end, and with many EUR issuers close to completing their 2018 issuance programmes (and some actually having overshot them), we are beginning to forecast their 2019 supply. Over the next few weeks, the debt agencies will be updating their funding plans and we will post the latest information as it becomes available.

So far, France and the Netherlands have published approximate funding estimates for next year. In addition, other Euro area governments have presented their 2019 draft budgets to the European Commission and some to their respective parliaments, with these still to be approved and then incorporated into their respective Treasury agency plans.

Chart 42: Net supply in the Eurozone (ex GR) *(€bn)*



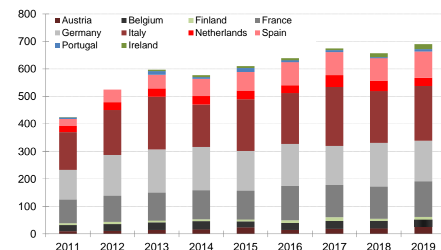
Source: Bloomberg, Santander

Table 4: 2019 net and gross supply by country vs. 2018

(€bn)	2019 Gross Issuance	% Change (vs 2018)	2019 Net Issuance	% Change (vs 2018)
Austria	28.0	51%	2.0	300%
Belgium	30.0	-3%	4.2	14%
Finland	11.0	0%	1.7	-39%
France	195.0	0%	64.8	-17%
Germany	140.0	-3%	-8.0	47%
Italy	246.2	12%	47.4	49%
Netherlands	26.5	15%	-3.3	79%
Spain	124.0	-8%	28.9	-36%
Portugal	15.0	-1%	6.0	-25%
Ireland	15.0	-6%	-3.1	-255%
TOTAL EZ (Ex GR)	830.7	3%	140.6	0%

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

Chart 43: Redemptions (ex GR) *(€bn)*



Source: Bloomberg, Santander

Draft 2019 budgetary plans sent to the EC help to estimate other EUR issuers' supply

Considering the Eurozone member states' 2019 draft budget plans (sent to the European Commission this October for approval), plus their 2019 redemptions, we have prepared our own estimates of gross issuance for next year. Our analysis for those countries that have not yet released their 2019 issuance estimates is based on the central governments' fiscal balance targets for 2019. We calculate the gross borrowing requirements for 2019 by adding this expected deficit to the amount of medium- and long-term bonds maturing next year (see Table 5). The difference between the initial estimates and the final programmes should be fairly small and will be corrected as their issuance programmes are published.

Gross supply to increase in 2019 while net supply is set to remain at the same level as in 2018

Over the last few years, Euro area countries have made efforts to comply with the 3% budget deficit target established in the EU's Stability and Growth Pact of 1998. The various fiscal stability plans have pushed net supply down in most countries over the last few years, and in 2019 we think we could have reached stability as net supply looks set to remain the same as in 2018 (Chart 42).

As shown in Table 4, our initial estimate of net issuance for 2019 is around €140bn (from €186bn in 2017 and €140.3bn in 2018, both excluding Greece). The countries expected to reduce their planned net borrowings the most next year, relative to 2018, are Ireland (-255%), Finland (-39%), Spain (-36%), Portugal (-25%), and France (-17%). On the other hand, we should see increases for Austria (+300%), the Netherlands (+79%), Italy (+49%), Germany (+47%), and Belgium (+14%). Our estimates may change as more information is released or new amendments to the draft budgets are made, such as possibly in Italy.

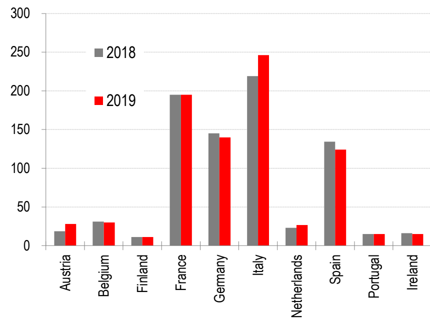
With bond redemptions increasing compared to last year, reaching the highest level of the last eight years (from €668bn last year to €690bn in 2019), we expect next year's gross supply to be €22-23bn (or +3%) higher than last year's, at c.€831bn (excluding Greece, which has no need to return to the markets next year, but if it does, is expected to be timidly active.

Table 5: Eurozone central governments' estimated gross borrowing requirements and redemptions in 2019

	2019 Redemptions & Coupon Payments																									2019 Bond Supply Target
	Jan		Feb		Mar		Apr		May		Jun		Jul		Aug		Sep		Oct		Nov		Dec		TOTAL	
(€bn)	R	C	R	C	R	C	R	C	R	C	R	C	R	C	R	C	R	C	R	C	R	C	R	C	Redempt	
Austria	-	0.2	-	0.2	11.3	1.5	-	0.4	-	0.2	7.3	0.4	-	1.2	-	-	0.1	0.6	7.2	0.6	-	0.4	0.1	-	26.0	28.0
Belgium	-	-	-	-	10.1	4.6	-	0.1	-	-	0.1	2.5	-	-	2.6	-	12.7	1.8	-	0.1	-	-	0.3	-	25.8	30.0
Finland	-	-	-	-	0.9	-	1.7	0.7	-	-	-	-	5.0	0.7	-	-	1.3	0.2	-	-	-	-	0.4	-	9.3	11.0
France	-	-	10.9	-	-	-	28.5	13.6	16.8	6.0	-	0.3	11.7	3.1	-	-	-	-	39.9	12.6	22.4	1.3	-	-	130.2	195.0
Germany	24.0	6.4	16.0	1.2	13.0	-	16.0	0.5	-	0.5	13.0	-	24.0	7.3	-	1.7	13.0	1.0	16.0	0.1	-	-	13.0	-	148.0	140.0
Ireland	-	-	-	0.2	-	1.2	-	0.5	-	0.6	7.1	0.5	-	-	-	-	1.0	-	8.0	0.7	2.0	-	-	0.2	18.10	15.0
Italy	-	-	23.1	5.1	23.9	11.6	10.9	0.8	28.7	6.0	-	1.9	1.0	0.4	15.6	4.7	40.8	11.1	26.7	0.8	12.4	5.7	15.7	1.9	198.8	246.2
Netherlands	14.9	3.7	0.7	-	-	-	-	-	-	-	-	-	14.2	2.9	-	-	-	-	-	-	-	-	-	-	29.8	26.5
Portugal	-	-	0.1	1.1	-	-	-	1.4	-	-	8.8	0.9	-	0.2	-	-	-	-	0.1	1.4	-	-	-	-	9.00	15.0
Spain	18.1	6.0	-	-	-	-	22.4	5.1	-	-	-	-	20.8	8.1	-	-	-	-	24.2	7.0	-	0.5	9.6	0.1	95.1	124.0
TOTAL EZ (€)	57.0	17.3	50.8	8.0	59.3	19.0	82.0	23.2	45.5	13.3	36.3	6.6	80.5	24.2	18.7	6.5	68.9	14.7	124.1	23.5	36.8	7.9	39.1	2.2	690.1	830.7

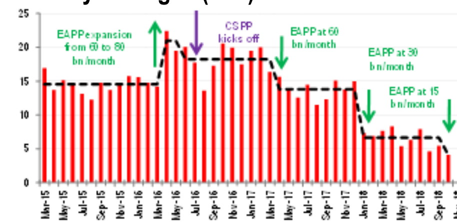
Source: Source: European Commission, EZ countries' debt agencies, Bloomberg, Santander. As per each country's draft budgetary plan for 2019, except for those issuers that have specifically announced their 2019 borrowing requirements (France and the Netherlands). The final numbers could differ if the treasury agencies decide to use other sources of funding (e.g. increasing/decreasing the net issuance of bills) or assume funding needs from other public issuers (agencies, regional governments, etc.)

Chart 44: Gross issuance by country, 2019 vs. 2018



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

Chart 45: The ECB's EAPP portfolio: monthly averages (€bn)



Source: Bloomberg, ECB, Santander

By country, Austria (+51%), the Netherlands (+15%), and Italy (+12%) should boost their planned gross borrowing needs next year versus 2018. On the other hand, Spain (-8%), Ireland (-6%), Belgium (-3%), Germany (-3%) and Portugal (-1%) are expected to scale back their gross issuance in 2019. Lastly, France and Finland should maintain similar levels of gross issuance as last year.

Update on the ECB's EAPP

The latest report published by the ECB on its Extended Asset Purchase Programme (EAPP) holdings includes the purchases settled as at 26 October. A total of €2.54trn worth of assets have now been bought since the programme began in March 2015 and which will soon finish in December. We recall that the ECB decreased its monthly EAPP purchases from €30bn to €15bn from October to December. The PSPP portfolio now amounts to €2.09trn, CBPP3 holdings total €260.4bn, the CSPP €173.5bn, and the ABSPP holdings are at €27.3bn in the 29 October report (more in our MMD report published a day later).

By country, the latest information available is a breakdown of PSPP debt security holdings published by the ECB on 2 October, which we commented on in detail in our MMD report of 3 October, including the expected monthly redemption amounts for the ECB's APP over a rolling 12-month horizon. In summary, the figures show that September PSPP purchases totalled €23.2bn, €21.5bn of which were EUR govies and agency debt (a €1.1bn increase vs. August) and the rest was supranational debt, which decreased by €522mn (see Table 6).

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

Holdings (€mn)	1Q18	2Q18	Jul'18	Aug'18	Sep'18	Monthly Change	Monthly Avge	2015 Purchases	2016 Purchases	2017 Purchases	YTD 2018 Purchases	Total Purchases
Austria	1,685	1,838	649	571	605	34	1,333	12,639	20,559	18,761	5,348	57,308
Belgium	2,184	2,339	826	724	730	6	1,681	15,895	25,939	23,630	6,803	72,268
Cyprus	-	-	-	-	-	-	5	285	- 37	- 35	-	214
Germany	14,666	17,600	6,346	5,422	6,318	896	11,853	115,618	188,321	155,372	50,352	509,670
Estonia	-	-	- 58	-	-	-	0	48	18	-	- 58	7
Spain	8,237	9,023	3,191	2,802	3,041	239	5,966	56,813	93,514	79,930	26,294	256,543
Finland	856	1,567	555	489	- 355	-844	751	8,086	13,212	7,872	3,112	32,277
France	12,192	13,268	4,697	4,121	4,219	98	9,634	91,762	149,100	134,901	38,497	414,266
Ireland	1,248	1,650	576	512	342	-170	689	7,581	10,982	6,719	4,328	29,608
Italy	10,481	11,528	4,069	3,598	3,630	32	8,373	79,204	130,398	117,120	33,306	360,032
Lithuania	- 126	78	42	41	163	122	72	1,107	1,157	640	198	3,101
Luxembourg	79	56	6	46	22	-24	60	1,115	628	642	209	2,593
Latvia	42	131	41	33	22	-11	47	685	628	430	269	2,013
Malta	43	38	- 11	8	2	-6	26	282	525	220	80	1,107
Netherl.	3,241	3,747	721	1,269	1,877	608	2,643	25,612	42,212	34,959	10,855	113,638
Portugal	1,412	1,811	638	562	546	-16	838	11,219	13,390	6,453	4,969	36,043
Slovenia	332	355	116	36	78	42	182	2,229	2,705	1,974	917	7,825
Slovakia	465	488	152	129	235	106	285	4,622	3,534	2,627	1,469	12,251
Sub Govies	57,039	65,519	22,555	20,360	21,474	1,114	44,436	434,802	696,794	592,213	186,947	1,910,764
Supras	6,441	7,315	2,465	2,259	1,737	-522	5,294	60,101	81,126	66,193	20,217	227,640
TOTAL PSPP	63,480	72,834	25,020	22,619	23,211	592	49,730	494,903	777,920	658,406	207,164	2,138,404

Source: ECB, Santander

Stuart Green
(+44) 33 114 80239

- **October Budget proves a more significant fiscal event than had been expected**
- **Chancellor Philip Hammond in effect chooses to spend an unexpectedly large fiscal 'gift' from the OBR's updated projections**
- **On some metrics, fiscal loosening amounts to 0.5%-pt of GDP per annum from 2019-20 onwards, but we believe that tax revenues may disappoint the updated projections in the months ahead**

OBR's new-found optimism feeds Hammond's generosity

The October 2018 UK Budget proved to be a more significant fiscal event than had been expected, with Chancellor Philip Hammond in effect choosing to spend an unexpectedly large fiscal 'gift' from the OBR's updated projections all in one go. The debate around whether this Budget truly marks an end to austerity is likely incomplete, with judgement postponed until the full details of next year's Comprehensive Spending Review are released (especially with regard to non-protected departmental spending). But, faced with the choice of either using the better fiscal projections to reduce borrowing and debt, or instead opt for a fiscal loosening, the Chancellor has chosen the latter, more activist option, announcing policy decisions which will amount to a GBP30bn per annum policy loosening by 2023-24.

Table 7: Key OBR fiscal projections, October versus March 2018

	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23
March 2018 OBR forecasts						
Real GDP, % growth	1.6%	1.5%	1.2%	1.3%	1.4%	1.5%
Nominal GDP, % growth	3.5%	3.0%	2.8%	3.0%	3.1%	3.3%
Output Gap, % potential GDP	0.2%	0.2%	0.1%	0.0%	0.0%	0.0%
PSNB, GBPbn	45.2	37.1	33.9	28.8	26.0	21.4
Cyclically-adjusted PSNB, % GDP	2.3%	1.9%	1.6%	1.3%	1.1%	0.9%
Cyclically-adjusted Current Budget, % GDP	-0.1%	-0.1%	0.5%	1.1%	1.2%	1.4%
PSND, % GDP	86.5%	86.4%	86.1%	83.1%	79.3%	79.1%
October 2018 OBR forecasts						
Real GDP, % growth	1.6%	1.4%	1.6%	1.4%	1.5%	1.5%
Nominal GDP, % growth	3.8%	3.3%	3.5%	3.5%	3.5%	3.6%
Output Gap, % potential GDP	0.1%	0.3%	0.3%	0.2%	0.1%	0.1%
PSNB, GBPbn	39.8	25.5	31.8	26.7	23.8	20.8
Change from March 2018	*-5.4*	*-11.6*	*-2.1*	*-2.1*	*-2.2*	*-0.6*
Cyclically-adjusted PSNB, % GDP	1.9%	1.4%	1.7%	1.3%	1.1%	0.9%
Change from March 2018	*-0.3%*	*-0.5%*	*0.0%*	*0.0%*	*0.0%*	*0.0%*
Cyclically-adjusted Current Budget, % GDP	0.1%	0.6%	0.6%	0.9%	1.1%	1.2%
Change from March 2018	*0.2%*	*0.7%*	*0.1%*	*-0.2%*	*-0.1%*	*-0.2%*
PSND, % GDP	85.0%	83.7%	82.8%	79.7%	75.7%	75.0%
Change from March 2018	*-1.5%*	*-2.7%*	*-3.3%*	*-3.4%*	*-3.6%*	*-4.1%*

Source: OBR, Santander

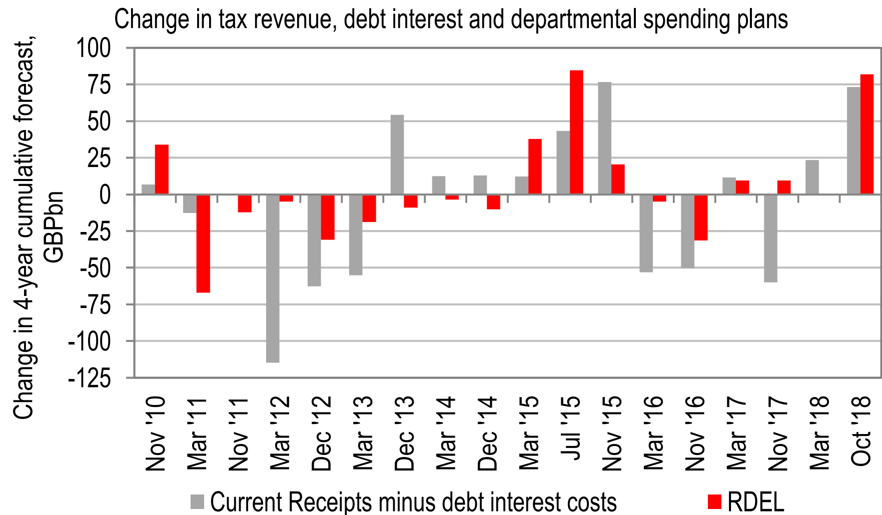
Some tax rises were announced, with the new Digital Services tax taking centre stage, even if it is designed to be narrowly targeted in nature. But more funding for public services, and a bringing forward of planned increases in income tax thresholds undoubtedly provided the headlines. Importantly, the nature of the OBR's updated fiscal projections essentially means that this fiscal loosening is designed to be 'painless', given the expectation that recent positive surprises on tax receipts will persist, more sustainably, in the future. Indeed, thanks to a more positive OBR view of the UK economy's long-run

potential, the margin of error versus the key fiscal mandate (around GBP15bn in 2020-21) is seen largely unchanged, even with the Chancellor's policy measures effectively increasing the structural deficit by around 0.5%-pt of GDP per annum from 2020-21 onwards.

The obvious question now relates to how the Bank of England will react to this loosening of the fiscal purse strings – particularly if they fail to share the OBR's optimism on potential GDP growth – and the upcoming November Inflation Report press conference will likely see several questions being fielded about the Chancellor's revised plans.

Given the MPC's existing forecast for an overheating of the UK economy to occur by H2-21, such fiscal stimulus would typically be seen as requiring an offsetting move in monetary policy, setting the stage for a more hawkish tone to emerge. However, based on the example provided by the July 2015 Budget Statement, and the MPC's analysis of the implied change in fiscal policy which featured in the August 2015 Inflation Report, we believe that the Committee could yet shy away from providing a definitive commentary on the likely implications of the latest fiscal change for monetary policy.

Chart 46: The change within departmental spending plans implied by the October 2018 Budget appears comparable to that indicated by the July 2015 Budget Statement



Source: OBR, Santander
Note: The chart shows the change (on a four-year ahead cumulative basis) within the OBR's tax revenue receipts (minus debt interest costs) and Departmental Expenditure forecasts implied by each Budget Statement released since November 2010

Chart 46, which attempts to provide a guide to the extent to which better (or worse) news on tax receipts has led to a change in spending plans, suggests that the July 2015 Budget implied a similar boost to departmental expenditure as that now suggested by the October Budget, while the planned pace of fiscal consolidation was also reduced by around 0.5%-pt of GDP per annum relative to the March 2015 projection (based on the cyclically-adjusted PSNB forecasts). However, despite containing a special analysis of the changes in fiscal policy implied by the July 2015 Budget, the August 2015 Inflation Report remained non-committal on the likely implications for growth, and it will interesting to see if a similar approach is adopted this time around

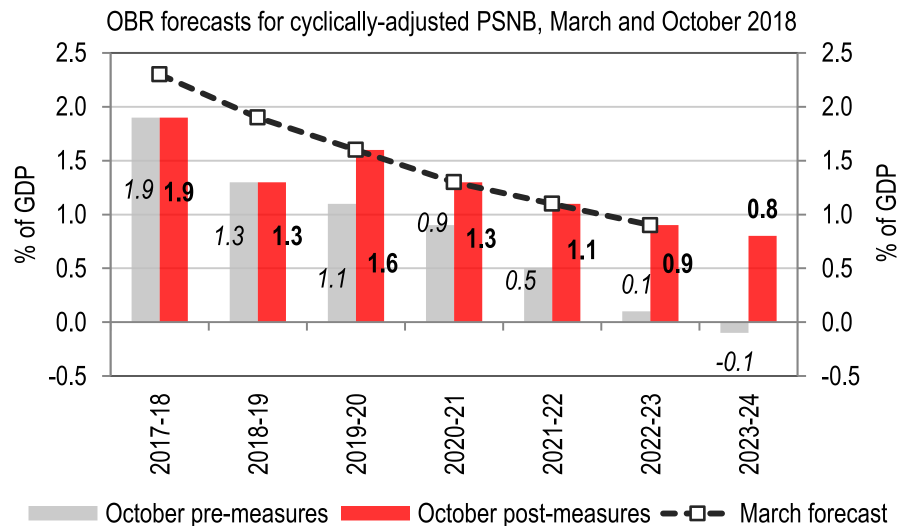
Borrowing forecasts for 2020 onwards lower than expected

In terms of the detail of the October Budget, the borrowing forecasts for both the current fiscal year and 2019-20 largely matched our expectations, with Public Sector Net Borrowing (PSNB) for 2018-19 now forecast to be

GBP25.5bn versus the GBP37.1bn expected back in March (we had looked for a GBP26.7bn figure), while borrowing for 2019-20 is now expected to be GBP31.8bn, slightly lower than the OBR's March forecast of GBP33.9bn, and our own estimate of GBP33.3bn (see Table 7). The larger surprises, however, were reserved for the later years of the forecast horizon, with the borrowing estimates from 2020-21 onwards actually experiencing small declines relative to our own expectation for initially small and then more material increases.

For the period 2020-21 to 2022-23, the borrowing forecasts have experienced a cumulative decline of GBP4.8bn relative to the OBR's March projections, versus our expectation of an increase of GBP35.1bn. Given the scale of this downside surprise, it is of course natural to look through the OBR's updated forecast to see exactly where and how this unexpectedly positive fiscal news has emerged, and we see three factors as key to the unexpectedly positive fiscal projections:

Chart 47: The Chancellor has chosen to spend his latest fiscal windfall, rather than balance the books



Source: OBR, Santander
Note: The chart shows the March 2018 OBR projections for cyclically-adjusted PSNB, the October 2018 OBR forecasts and those which would have resulted had no discretionary changes within fiscal policy occurred in the October Budget.

1) Nominal GDP seen larger, and growing faster:

Firstly, it is worth highlighting that the fiscal boost does not relate to an unexpectedly large upgrade to the outlook for real GDP growth. The OBR has lifted its 2019 GDP forecast to 1.6% from 1.3% previously, while the smallest of upgrades were also pencilled in for 2020 and 2021, but this good fiscal news follows the 2018 headline growth forecast being revised lower, to 1.3% from 1.6% previously. Rather, the good news came in relation to nominal GDP growth, which is of course the most important parameter with regard to fiscal policy. The estimate for the current level of nominal GDP has been revised higher (by around 0.5%-pt), and a faster pace of expansion is now expected through the forecast period, with the OBR now anticipating a 16.3% increase in nominal GDP between Q3-18 and Q1-23, versus the March forecast of 14.6%.

2) 2018-19 tax take surprise forecast to persist:

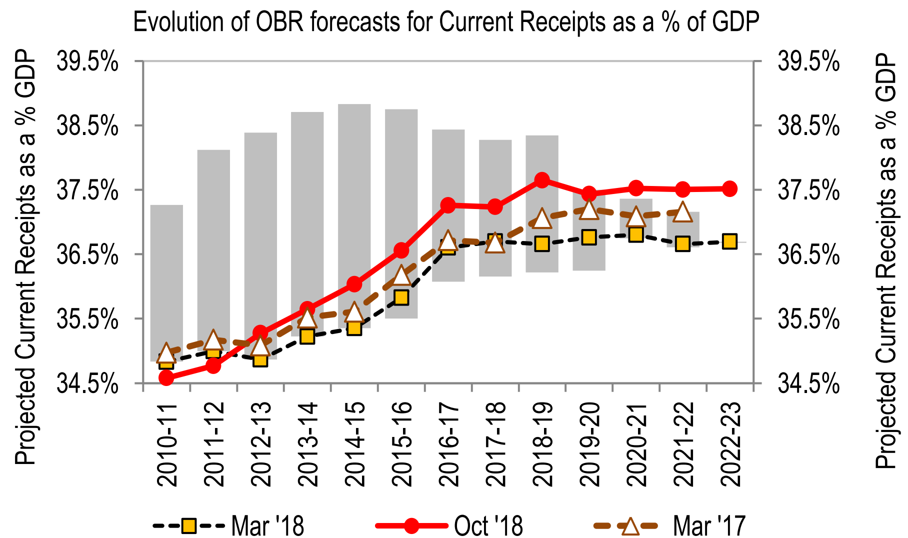
As well as the assumption of a larger nominal economy, the OBR now also expects tax receipts to constitute a significantly higher proportion of this

enlarged GDP. Under the March projections, tax receipts were seen standing at around 36.7% of GDP through the forecast horizon, but this estimate has now increased to around the 37.6% level, thereby compounding the good news with regard to nominal GDP. In essence, the OBR appears to have assumed that the unexpectedly good news on tax receipts in the current fiscal year will persist through the forecast horizon, and we believe this to be a risky strategy given the manner in which tax receipt forecasts have typically fallen short of prior estimates in recent years (see Chart 48).

3) UK's potential growth rate revised higher:

Finally, and perhaps most surprisingly, the OBR has also raised its estimates of the economy's potential growth rate, with a 7.2% increase in potential GDP now expected between Q3-18 and Q1-23, versus 6.7% previously. The source of this increased estimate appears to relate more to the assumed equilibrium levels of labour market participation and unemployment rather than any major increase in the productivity assumption and, on balance, we believe that the OBR is likely justified in making these changes. However, regardless of the merits of the move, the implications for fiscal policy are unambiguously positive, both with regard to the perceived sustainability of growth, and by helping to avoid more damaging output gap estimates from materialising. Even after the implied fiscal loosening, the cyclically-adjusted PNSB figure is seen standing at 1.3% of GDP in 2020-21 – unchanged from March – and the OBR's change in view on potential growth rates has helped in this regard.

Chart 48: Tax revenue forecasts have proved a constant source of disappointment



Source: OBR, Santander.
Note: Chart shows the March 2017, March 2018 and October OBR forecasts for current receipts as a share of nominal GDP. The chart also shows the range of OBR forecasts for current receipts as a share of nominal GDP, taken from each Budget Statement released between June 2010 and March 2018.

The net result of these changes has been to create the expectation of a larger, more 'tax rich' economy than was previously envisaged, and with the balance between demand and supply also helpfully remaining largely unchanged from previous estimates. Such a change in view is clearly good news for any Chancellor, and Philip Hammond has in effect chosen to spend this fiscal dividend all in one go, even though the risks of a hard Brexit scenario would appear to have increased in recent months.

Table 8: The CGNCR forecasts have experienced a disproportionately large decline

GBPbn	2018-19	2019-20	2020-21	2021-22	2022-23
Public Sector Net Borrowing	25.5	31.8	26.7	23.8	20.8
Change from March 2018	-11.6	-2.1	-2.0	-2.2	-0.6
Central Govt. Net Cash Req.*	**31.2**	**27.6**	**49.1**	**43.7**	**43.1**
Change from March 2018	-9.4	-14.7	-3.4	-4.9	-7.3
Gilt redemptions	66.7	99.1	97.6	79.3	73.3
Planned financing for reserves	6.0	6.0	0.0	0.0	0.0
Financing adjustment carried forward	-1.4				
Gross Financing Requirement	**102.5**	**132.7**	**146.7**	**123.0**	**116.5**
Change from March 2018	-9.5	-14.7	-3.4	-4.9	-7.3
Contribution from NS&I	9.0	6.0	6.0	6.0	6.0
Other financing	0.0	0	0	0	0
Planned financing from t-bills	-4.0	6.0	6.0	6.0	6.0
Illustrative gross gilt issuance	**97.5**	**120.7**	**134.7**	**111.0**	**104.5**
Change from March 2018	**-8.5**	**-14.7**	**-3.4**	**-4.9**	**-7.3**

Source: DMO, OBR, Santander.

Major forecast revisions could therefore emerge in the spring should a “no-deal” outcome materialise, with the implications for future gilt issuance potentially suffering a double whammy. While the cumulative reduction in borrowing forecasts for the period 2018-19 to 2022-23 amounted to GBP18.5bn, the decline in CGNCR forecasts – helped by the assumption of additional asset sales – amounted to a very large GBP39.7bn, suggesting that a lot of good news is currently incorporated into the cash requirement figures.

UK Rates Strategy: Brexit stasis exacerbates risk aversion

Adam Dent
(+44) 33 114 80240

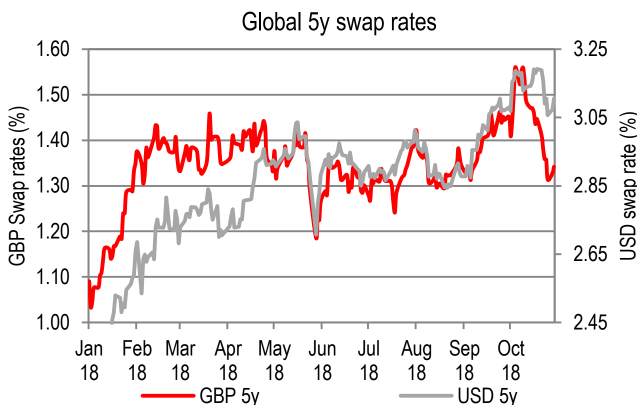
- **The Brexit process remains firmly trapped in the "no deal, yet" scenario of the three we explored in a note on 17 October**
- **Short rates are roughly where we expected in that situation, but long rates moved much more than we expected in late October's global rally**
- **We expect UK rates to bear-steepen back, potentially starting with help from the Bank of England's MPC on 1 November**
- **5y has richened the most, in relative terms, so we like steepeners (1s2s, 2s5s or even 2s10s) or, our favourite, paying a 2s5s10s fly**
- **The Budget delivered a surprisingly large reduction in gilt supply, especially in the next five months but also on a five-year horizon**
- **We see the OTR 1F 28s as set to benefit the most from the changes**

Brexit seems stuck roughly where it was a month ago…

Another European summit has been and gone, and there is no material progress to report towards finalising the UK's Withdrawal Agreement with the EU. The Irish border backstop remains the seemingly insoluble sticking point, as we explored last month. Technical discussions might be grinding out progress behind the scenes, but there has been no evidence of any top-level discussions since the Council meeting. The only thing that appears to have changed is that holding a summit in mid-November to conclude the deal has gone from a slim chance to almost no chance.

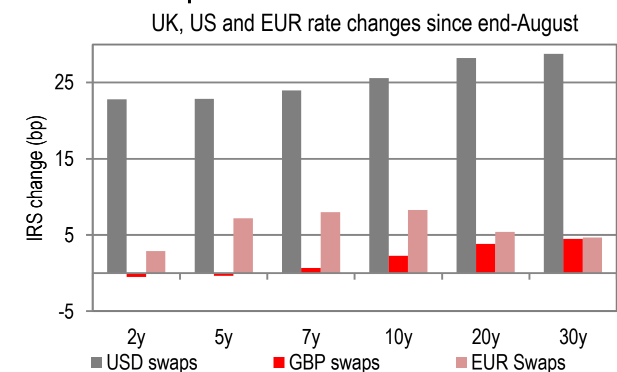
Market pricing for a hard, no-deal outcome has remained very limited, as far as we can tell, with the lack of progress (but warmer words) at the leaders' October meeting making no clear impact on UK rates. However, the UK's particularly precarious situation did help exacerbate its reaction to the global risk-off rally towards the end of October (Chart 49), whose causes and effects are explored in the other Rates sections of this report. This move took UK rates at all tenors back to roughly where they ended August, despite the intervening rises proving more durable elsewhere (Chart 50).

Chart 49: The latest risk-off rally has pushed UK rates back to where they ended August, breaking the close relationship with moves in the US that had prevailed for the previous six months



Source: Bloomberg, Santander.

Chart 50: This divergence was seen all across the curve, not just the monetary policy-driven front end, and even helped GBP rates to outperform EUR ones



Source: Bloomberg, Santander.

…but markets can swing back towards optimism anyway

Ahead of the EU27 dinner, on 17 October, we published a note considering how the UK rates market might react under three broad scenarios for how the Brexit negotiations could unfold in the short run (i.e. over the following few weeks):

1. No agreement, yet (negotiations continue into December)
2. Hard "no-deal" Brexit (negotiations break down)
3. Negotiated Brexit (an agreement is concluded swiftly)

We have so far remained firmly in the "not yet" scenario, and short rates are sitting close to where we expected that to put them (Table 9). Longer term rates, however, are rather lower than we expected them to be – unfortunately for the GBP 2s10s steepener trade that we suggested in the previous edition of the I&E, on 4 October.

We still see a Withdrawal Agreement as more likely to be reached than not, and probably before the end of 2018, but progress is likely to remain slow. But a key theme that we emphasised when considering the Brexit scenarios is the market's persistence in hoping for the best, and eventually managing to see the silver linings in all but the darkest of storm clouds.

For instance, we have yet to see any media pundits make claims along the lines that "the prospect of Merkel's departure clears the way for the EU to be more accommodative on Brexit", and see little validity in such reasoning, but would not be surprised if it is invoked at some point to justify/explain a bounce in UK rates.

One way or another, we see a bear-steepening as the UK's most likely trend over the coming month.

Table 9: UK rates today, and how we believe they might evolve under different Brexit paths in coming weeks

Scenario	30 October	No deal, yet	Hard "no-deal" Brexit	Negotiated Brexit
2y GBP OIS	0.88%	0.90%	0.70%	1.05%
2y GBP IRS (6s)	1.09%	1.15%	1.05%	1.25%
2y gilt	0.72%	0.75%	0.45%	0.90%
10y GBP IRS (6s)	1.54%	1.85%	2.20%	1.90%
10y gilt	1.40%	1.65%	2.05%	1.80%
Corp Index OAS	1.53%	1.70%	2.00%	1.10%

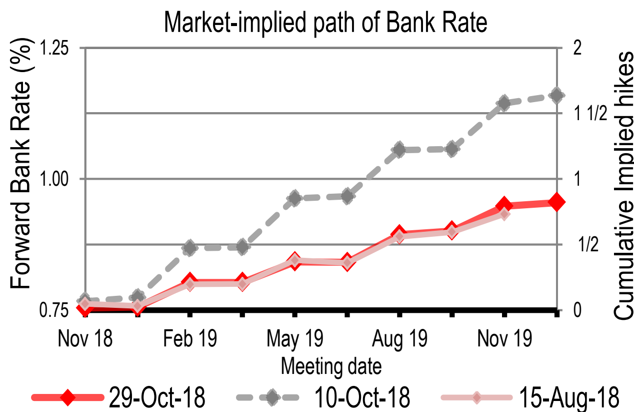
Source: Bloomberg, Santander.

BoE risks likely have a hawkish bias tomorrow

We set out our detailed expectations around the BoE's 1 November meeting in a preview on 30 October (More heat than light?). Although we expect little change in the MPC's key messages, we see a hawkish signal as more likely than a dovish one, perhaps from higher wage growth forecasts and/or acknowledging the circa 0.5%-pt of GDP per annum effective fiscal stimulus delivered in the Budget (see the UK Economics section, above, for more details on those fiscal developments).

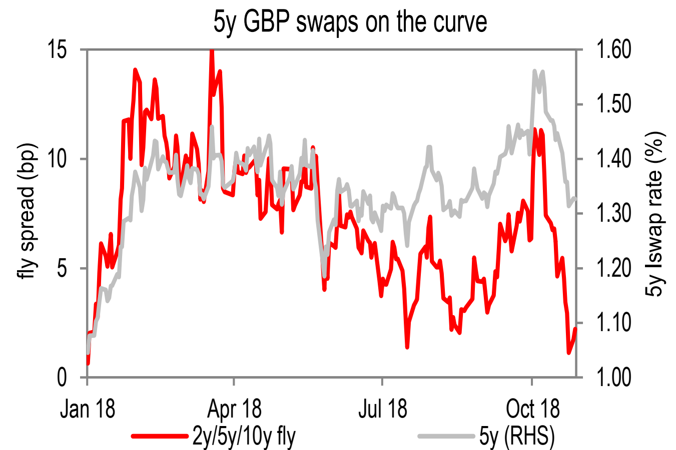
Most importantly, the rally has pushed Bank Rate expectations back to their lowest since the August hike became widely priced in (Chart 51). Barring an evident and sharp deterioration in the Brexit negotiations or the UK government's stability, we believe some more risk premium should soon return to this profile – and the hawks on the MPC are likely to take this week's opportunity to remind the market of their preferred path.

Chart 51: Bank Rate expectations are also back to their lowest since the last hike was delivered at the start of August, after peaking at 1⅔ by the end of 2019 as recently as mid-October



Source: Bloomberg, ICAP, Santander.

Chart 52: 5y has performed particularly strongly on the GBP rate curve, and is our favoured area to position for a rebound



Source: Bloomberg, Santander.

We are still highly dubious about a hike actually being delivered within the next 12 months, but still see current pricing as too complacent. In particular, the risks of hikes in 2020 seem unsustainably low, so a steeper short end would make sense.

Our 2s10s steepener would stand to benefit from such a rebound despite its receive-2y leg, as the curve has shown strong bear-steepening / bull-flattening behaviour recently. Over the medium term (next month or two) we still like that position, as we doubt the 10y UK-US rate gap can stay this wide for long but the short leg is likely to remain bound to its recent range (whose limits are sketched out in Chart 51).

However, from a tactical perspective, we see 5y as the most stretched area (or 2y2y for investors who prefer forward swaps). Outright 5y paying positions, 2s5s or even 1s2s steepeners would make sense, but we consider the best value expression to be a 2s5s10s fly.

Trade idea: Pay 5y on a GBP 2s5s10s fly.

Enter at a spread of 3bp, targeting 7bp, with a stop at 0bp.

Close trade idea: GBP 2s10s steepener

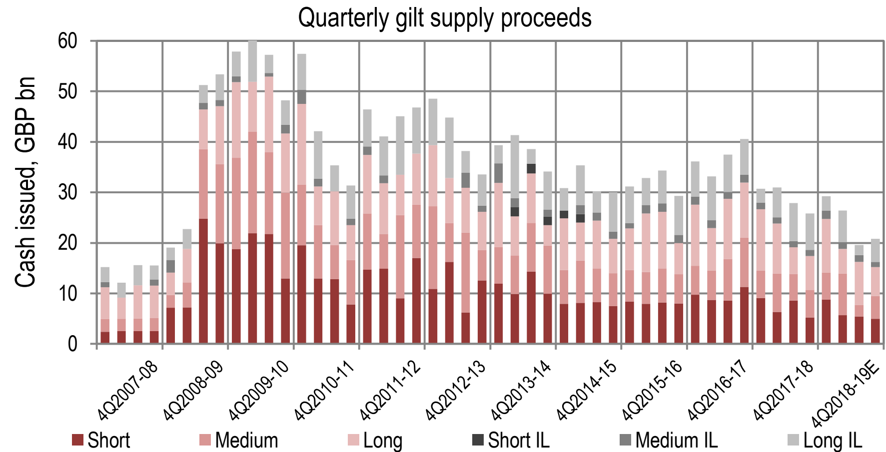
Entered at 53bp, currently at 46bp. This position would be a reasonable macro alternative to the 2s5s10s fly, and we will be looking for opportunities to switch back into this position if/when the current richness of 5y unwinds.

Gilt remit implications: famine then feast

The Budget revised this fiscal year's gross gilt supply down by GBP8.5bn to GBP97.5bn: by far the smallest target since before the 2008 financial crisis. As the DMO was already ahead of schedule, the supply remaining over the next five months is equivalent to just a GBP56bn annualised pace, almost one third slower than the first quarter of this fiscal year (Chart 53). Each auction left this year has been reduced by almost GBP0.5bn, and the remaining (IL41s') syndication by GBP0.7bn.

The net picture is even more favourable, as there are GBP9.7bn of nominal coupon payments and a GBP33bn redemption between now and the end of March (which will trigger over GBP20bn of APF reinvestments.

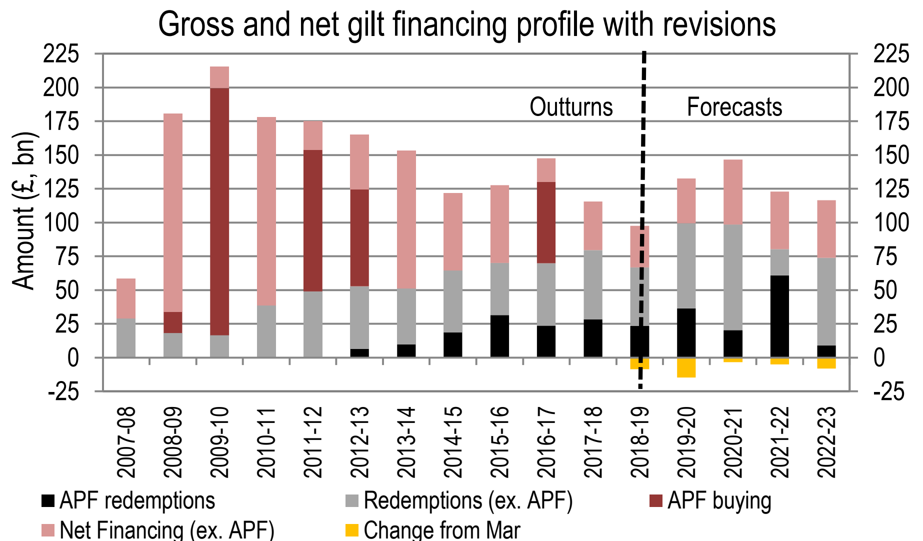
Chart 53: Gilt sales in the remainder of this fiscal year will be the slowest since mid-2008



Source: DMO, Bloomberg, Santander.

This very thin spell will not last for long, though, as 2019-20 is still forecast to see around GBP130bn of gilt sales even in a smooth Brexit scenario (Chart 54). Still, the DMO/OBR's cumulative gilt supply projections over the coming four years are still around GBP30bn lower than at the Spring Statement, so yesterday would appear to be a very gilt-supportive fiscal event.

Chart 54: Gilt supply projections are now lower in each year of the OBR's forecast than they were at the Spring Statement, but next year still presents a sharp reacceleration



Source: DMO, OBR, BoE, Santander.

However, in the light of gilts' strong recent performance, we believe any outright rally or outperformance versus swaps will be a great challenge, without assistance from rates elsewhere. We therefore prefer RV or curve expressions. We highlighted these yesterday, in the wake of the Budget

<u>Trade idea:</u> Buy the OTR 10y gilt (1F 28s) versus its surroundings

Current 4Q 27s/1F 28s spread 14.5bp, target 12bp with a stop at 15.5bp

10y gilts were already facing an historically light period of supply, with next week's tap their only one left in 2018, and that sale just shrank by about 15%. Even if this gilt remains on the run a little longer than usual, for the whole of the current fiscal year, it would still end up with a total outstanding nominal of barely £23bn, the smallest of any gilt in the front 20y of the curve (aside from the other, 6%, 28s). Although they have performed well on local flies over the last couple of months, and held on to that performance despite the sharp reversal of outright yields over the last couple of weeks, that is pretty typical at

this late stage of their OTR lifecycle.

They (and 10y in general) were, perversely, the weakest point on the gilt curve on the day of the Budget, despite standing to benefit particularly from the supply revisions, although they did recover slightly the next day. In contrast, the other OTRs (1% 24s and 1T 49s) are much earlier in their lifecycles and will have plenty of time to catch up during next year's heavier issuance.

Note also that the 1F 28s have just dropped below 10y to maturity, opening up the potential for <10y-benchmarked investors to start buying them – they offer an enticing 10bp of yield (or 6bp of ASW) pick-up over the cheapest gilt currently available to such mandates.

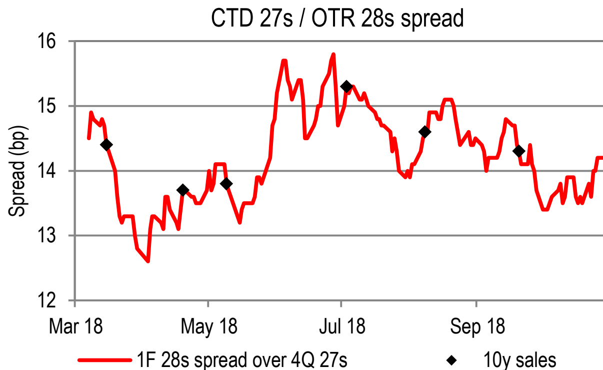
We already have an open recommendation to **buy the 1F 28s vs. 4Q 27s** (Chart 55), 0.7bp offside of where we entered it on 19 April, and reiterate that idea or a **1Q 27s/1F 28s/4T 30s fly** (regression weights would be -89:100:-9) based on the current supply dynamics.

<u>Trade idea:</u> Buy the OTR 10y gilt (1F 28s) versus 5y (0T 23s)

Current spread of 42bp, targeting below 40bp with a stop at 44bp

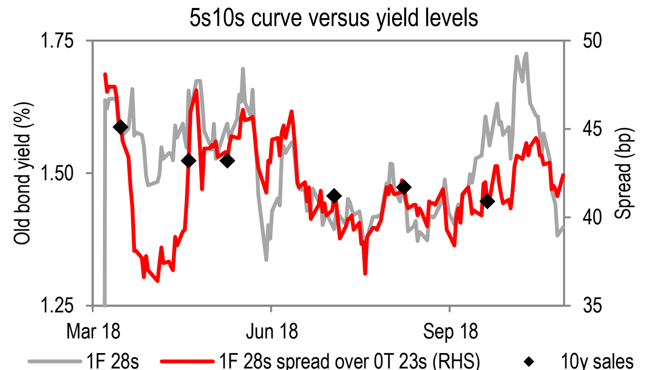
The 5y sector has outperformed its beta to 10y recently, leaving the curve (and ASW box) steeper than would be expected given the rally (Chart 56). This puts the 28s 2bp cheap on regression vs. the 23s. This curve trade is directionally vulnerable to a swift return of risk appetite, but we see further geopolitical risks as likely to keep a lid on that in the short run – allowing supply dynamics to take precedence for now.

Chart 55: The 10y gilt has cheapened up versus the CTD 27s, but should now benefit from the light supply



Source: Bloomberg, DMO, Santander.

Chart 56: We see gilt 5s10s as rather steep given yield levels and supply dynamics



Source: Bloomberg, DMO, Santander.

Stuart Bennett
(+44) 33114 80134

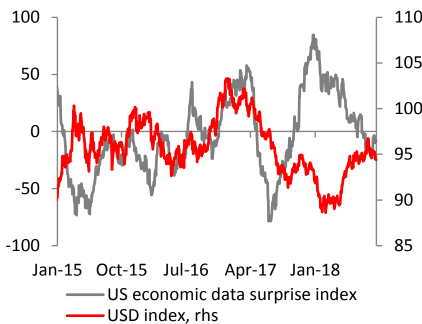
Taken from our latest FX Compass, published 25 October

USD – Steadily advancing again

The USD appears set to remain on the front foot. US data is robust, the Fed is likely to raise rates again before the end of the year, and lower global risk appetite continues to fuel the dollar as a safe haven. However, the result of the US mid-term elections, the US administration's criticism of rate hikes, worries about the rising US deficit and debt, as well as concerns that an even stronger dollar risks softening both the growth and inflation outlooks should contain upside pressure on the currency.

The US economy continues to outperform its peers. US growth was 3.3% QoQ annualised in Q3-18, slower than the 4.2% posted in Q2. We expect the US to grow 2.8% in 2018 and 2.7% in 2019, notably above the expected Eurozone growth of 2.3% and 2.2%, respectively. Consequently, such a growth dividend, at a time when markets are concerned about downside risks to global growth, continues to support the dollar.

Chart 57: USD strength may now be in line with the US economy's strong performance



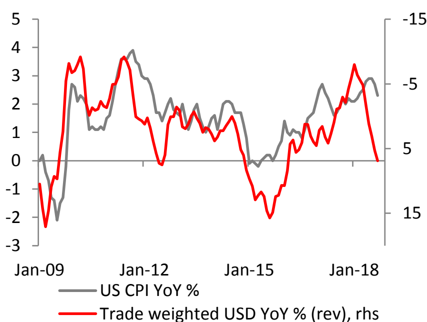
Source: Citi, Bloomberg, Santander

However, US data are no longer providing the persistent upside surprises that they were earlier in the year. But neither are the data from other developed market economies, which may have blunted the US effect on the dollar. In addition, the relationship between economic data surprises and the USD again highlights the dollar's largely unjustifiably poor performance in Q1-18. At the start of the year US data were outperforming forecasts, but the USD was struggling. Given this, we could argue that the strong dollar performance since Q2 has been helped by the currency catching up with the lead set by the strong economy.

The strength of the economy and inflation allowed the Fed to hike rates again at its September meeting. The minutes of that meeting indicate that more rate hikes are likely. We expect another increase in December, and two more in 2019. Further rate hikes should be expected and are already priced into the USD, but suggestions by some members of the FOMC that rates need to rise further have also kept the dollar firm.

However, the minutes also reflected some concern as to the threat posed to activity by a strong dollar. The USD index is currently around 2.5% higher than it was at the time of September FOMC. Hence, policymakers' concern over the strong USD may also slow its advance, as might the US administration's criticism of the FOMC policy of hiking rates. President Trump recently called the Fed his "biggest threat" and blamed it for stock market sell-offs during the past month.

Chart 58: More USD strength could pull inflation lower and question the need for more US rate hikes



Source: Bloomberg, Santander.

Low global risk appetite, evidenced by weak equities, and trade tensions, continue to favour the USD as a safe-haven currency. The US mid-term elections on 6 November will be a focus for the USD, but their effect on the dollar seems ambiguous. If the Republicans lose control of Congress, would that be viewed as USD-positive, or would it encourage the government to move forward with more populist policies, including tax cuts to win back support ahead of the 2020 presidential election?

Hence, US risks, particularly focussed on the budget, may become more of a USD-negative factor over the coming months. Moody's recently warned that without offsetting policies, the debt burden will continue to rise, resulting in an overall weaker fiscal profile for the US.

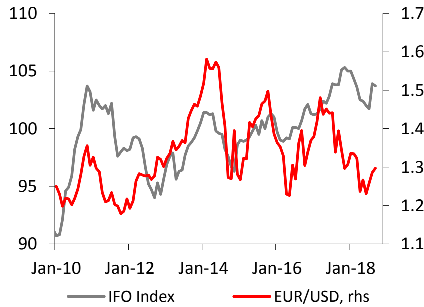
EUR – Fiscal conflict woes

The EUR has been under pressure for much of October, and there is little indication that this pressure will reverse over the coming weeks. A strong US dollar continues to weigh on EUR/USD, as it does on the other USD/G10 pairs, and soft Eurozone economic sentiment has recently added to the EUR's woes.

We still favour EUR gains over the forecast horizon, but have lowered our forecast to reflect the current drop in spot, which looks likely to be sustained over the coming weeks.

We note that it has been the yen, and not the USD, that has performed best against the EUR in October. The JPY's gains provide a clear signal as to why the EUR has been weak, namely low risk appetite. EUR/JPY has been pulled lower by worries about global growth, weaker equities, but in particular concerns about Italian politics and fiscal policy and their impact on Europe.

Chart 59: Softer Eurozone data may be weighing on the EUR, but the robust outlook remains positive for the currency

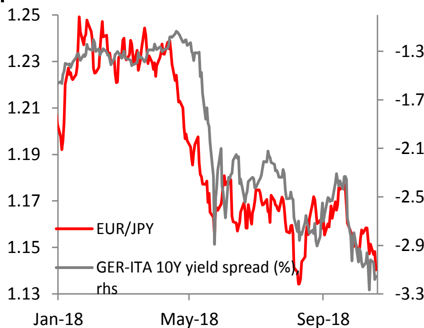


Source: Bloomberg, Santander

We recall that the Italian government adopted a budget deficit target of 2.4% of GDP over the next three years. This is above the 0.8% targeted by the previous administration, and will imply that the Italian debt to GDP ratio, currently at 135% of GDP, edges up over the next few years. The EU has rejected the budget and given the Italian government until mid-November to put forward a new one. However, the Italians have indicated they will not alter their plans. Hence, the fiscal conflict between Italy and Europe is set to continue and keep the EUR vulnerable into November.

As the budget tension has mounted, the Italian ten-year yield has risen, reaching a high of 3.68% on 18 October. The spread between this and the German ten-year yield has been used recently as a gauge of Italian/Eurozone risk. In October the spread reached its widest level since Q1-13. The correlation between the German-Italy ten-year spread and EUR/USD has been 0.91 so far in 2018. At the moment, the spread suggests that EUR/USD is accurately valued at around 1.1400. It may require an even wider yield to pull the EUR lower. Given that it is already at a multi-year high, this may be difficult to generate or sustain, but the uncertainty surrounding the Italian budget over the next few weeks should keep the EUR hovering around its current levels.

Chart 60: EUR weakened as EUR-specific risk increased; it may be unable to strengthen until/unless this risk pressure abates



Source: Bloomberg, Santander

The recent underperformance of some Eurozone economic data has also weighed on the currency. However, we suspect that without the backdrop of Italy, the data may not have been sufficiently weak to undermine the currency by itself. Economic sentiment has slipped during the last few months, but the PMIs and IFO, although softer, still point to growth in both the manufacturing and services sector. Meanwhile, consumer confidence, IP and trade data have all surprised to the upside.

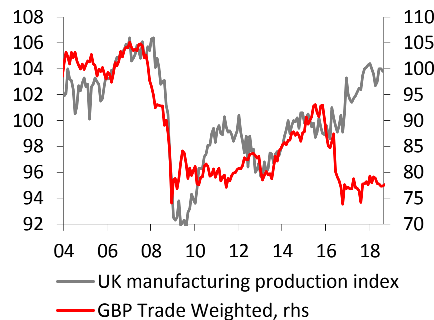
Indeed, we still expect robust economic growth in the Eurozone, and forecast 2.3% growth this year and 2.2% in 2019. The ECB kept its policy unchanged at its October meeting, but with growth firm, headline inflation above target and Draghi reiterating that the acceleration of wages implies that the bank is confident that inflation will remain elevated, the ECB remains on course to remove its monetary policy accommodation and hike rates in 2019, which together with an assumption that current risk factors will fade, should still allow the EUR to gradually and sustainably strengthen.

GBP – The final countdown?

Sterling should remain vulnerable to Brexit uncertainty over the coming month. In addition, we expect the UK economy to underperform its peers and the BoE to keep rates on hold in 2019, both factors that should cap the pound's upside potential.

If an EU withdrawal agreement is not reached, and whether this can be achieved should become clearer over the next month, the pound is likely to weaken significantly. GBP/USD lost around 15% in the two weeks after the referendum. We do not believe that the reaction to a 'no-deal' Brexit will be quite as large, and focus on a 7% drop. However, as always, the knee-jerk reaction would probably see GBP/USD overshooting, before stabilising.

Chart 61: Sterling remains cheap, given UK fundamentals, which prevents a further big sell-off



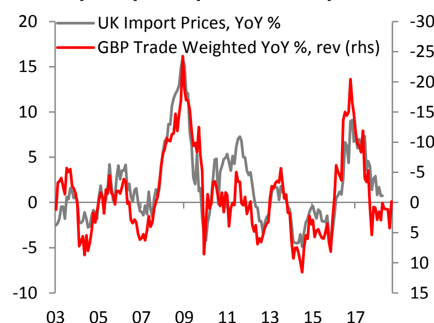
Source: Bloomberg, Santander

Further, several factors could support the pound, or at least limit its fall, in the event of a 'no-deal'. First, sterling is already cheap, around 12% down from its pre-referendum level and weaker than fundamentals suggest it should be. Second, many market participants are already short sterling, which may limit the market's ability to bet further against the pound. Third, we think the USD may be too strong, and a softer dollar would support GBP/USD.

If a withdrawal agreement is reached, we expect this to boost GBP/USD by 3-4%, although, again, the market will probably over-react in the short term and pull the pair up by more. But, whilst the market may be relieved by an agreement, uncertainty will remain, which should prevent the pound from appreciating further. First, UK political uncertainty will persist, i.e. will parliament approve the deal? Second, even if it is approved, trade negotiations may also imply currency-negative uncertainty.

Plus, in the medium term, whatever new trade deal is agreed between the UK and EU, it is unlikely to involve the same level of market access that the UK currently has. Hence, to account for this, the GBP may have to be permanently weaker than it was pre-referendum to provide the UK economy with competitive help.

Chart 62: Another drop in the pound would put upside pressure on prices



Source: Bloomberg, Santander

Brexit issues will also have an impact on UK growth, inflation and interest rates, which in turn will feed into the FX market. Even if a 'deal' is agreed, we do not expect UK growth to exceed 1.5% either this year or in 2019. Further, we suspect that headline CPI will fall below the BoE's 2% YoY target in 2019. Hence, contrary to market expectations, we do not expect the Bank to hike rates until 2020. This should keep GBP/USD under pressure. If a deal is not struck, we believe that growth in 2019 will be weaker than forecast, and, even though inflation will be higher (due to tariffs and the impact of a cheaper pound), the Bank is still not expected to hike rates, given the possible negative impact on sentiment.

The EUR/GBP outlook will depend on Brexit, but may also be driven by movements in the USD, concerns about Italian risk and ECB rate hikes. In a no-deal scenario, we expect the EUR to be negatively affected, but less so than the pound, so EUR/USD should weaken, but EUR/GBP should strengthen. Hence, this would imply upside risks to our forecast, which is for EUR/GBP to hover around or above 0.90 over the next year or so.

If a withdrawal agreement is negotiated, we think this will tend to be EUR/GBP negative in the short term as the pound benefits from a relief rally, but that this could fade as ongoing uncertainty, a better Eurozone outlook and ECB rate hikes help the cross.

Table 10: G10 FX forecasts

	Q4-18	Q1-19	Q2-19	Q3-19	Q4-19	Q1-20
EUR-USD	1.17	1.20	1.22	1.23	1.24	1.25
GBP-USD	1.32	1.32	1.33	1.35	1.36	1.37
GBP-EUR	1.13	1.10	1.09	1.10	1.10	1.10
EUR-GBP	0.89	0.91	0.92	0.91	0.91	0.91
USD-JPY	116	118	120	118	116	114
EUR-JPY	136	142	146	145	144	143
USD-CNY	6.80	6.80	6.70	6.70	6.70	6.65
EUR-CNY	7.96	8.16	8.17	8.24	8.31	8.31
EUR-CHF	1.16	1.18	1.19	1.20	1.20	1.21
USD-CHF	0.99	0.98	0.98	0.98	0.97	0.97
EUR-SEK	10.3	10.2	10.0	9.8	9.6	9.5
EUR-NOK	9.3	9.1	9.0	8.8	8.7	8.6
USD-CAD	1.25	1.22	1.20	1.20	1.19	1.18
AUD-USD	0.73	0.73	0.74	0.75	0.76	0.77
NZD-USD	0.67	0.68	0.68	0.69	0.70	0.71

Source: Santander

Euro interest rate forecasts

Government Bond yield Forecasts

Bunds	Current	4Q18	1Q19	2Q19	3Q19	4Q19
ECB Refi	**0.00**	**0.00**	0.00	0.00	0.30	**0.50**
ECB Depo	**-0.40**	**-0.40**	-0.40	-0.40	-0.20	**0.00**
3m	**-0.82**	**-0.72**	-0.53	-0.40	-0.20	**0.00**
2y	**-0.62**	**-0.45**	-0.25	-0.05	0.20	**0.40**
5y	**-0.19**	**0.00**	0.25	0.50	0.75	**0.90**
10y	**0.39**	**0.60**	0.90	1.15	1.35	**1.55**
30y	**1.02**	**1.20**	1.40	1.60	1.80	**1.95**

Swap rate forecasts

€ swaps	Current	4Q18	1Q19	2Q19	3Q19	4Q19
ECB Refi	**0.00**	**0.00**	0.00	0.00	0.30	**0.50**
ECB Depo	**-0.40**	**-0.40**	-0.40	-0.40	-0.20	**0.00**
3m	**-0.32**	**-0.33**	-0.27	-0.17	-0.01	**0.22**
2y	**-0.12**	**0.00**	0.15	0.30	0.50	**0.70**
5y	**0.36**	**0.50**	0.70	0.90	1.10	**1.25**
10y	**0.96**	**1.15**	1.40	1.60	1.75	**1.90**
30y	**1.51**	**1.65**	1.80	1.95	2.10	**2.20**

US interest rate forecasts

Government Bond yield Forecasts

USTs	Current	4Q18	1Q19	2Q19	3Q19	4Q19
FOMC (mid)	**2.125**	**2.375**	2.625	2.875	2.875	**2.875**
3m	**2.33**	**2.40**	2.65	2.90	3.00	**3.10**
2y	**2.88**	**3.05**	3.25	3.40	3.50	**3.60**
5y	**2.99**	**3.20**	3.45	3.60	3.65	**3.70**
10y	**3.15**	**3.25**	3.45	3.60	3.70	**3.80**
30y	**3.38**	**3.40**	3.50	3.55	3.60	**3.65**

Swap rate forecasts

$ swaps	Current	4Q18	1Q19	2Q19	3Q19	4Q19
FOMC (mid)	**2.125**	**2.375**	2.625	2.875	2.875	**2.875**
3m	**2.56**	**2.55**	2.80	3.00	3.10	**3.15**
2y	**3.08**	**3.20**	3.35	3.45	3.50	**3.60**
5y	**3.14**	**3.30**	3.50	3.60	3.60	**3.65**
10y	**3.22**	**3.30**	3.45	3.55	3.65	**3.70**
30y	**3.28**	**3.30**	3.35	3.40	3.40	**3.45**

UK Interest rate forecasts

Government Bond yield Forecasts

Gilts	Current	4Q18	1Q19	2Q19	3Q19	4Q19
MPC	**0.75**	**0.75**	0.75	0.75	0.75	**0.75**
3m	**0.79**	**0.70**	0.70	0.73	0.77	**0.77**
2y	**0.76**	**0.90**	1.00	1.00	1.10	**1.10**
5y	**1.03**	**1.35**	1.40	1.50	1.60	**1.65**
10y	**1.44**	**1.70**	2.00	2.10	2.10	**2.20**
30y	**1.86**	**2.00**	2.40	2.50	2.60	**2.65**

Swap rate forecasts

£ swaps	Current	4Q18	1Q19	2Q19	3Q19	4Q19
MPC	**0.75**	**0.75**	0.75	0.75	0.75	**0.75**
3m	**0.82**	**0.80**	0.80	0.83	0.85	**0.85**
2y	**1.12**	**1.25**	1.35	1.30	1.35	**1.30**
5y	**1.37**	**1.65**	1.65	1.70	1.80	**1.75**
10y	**1.59**	**1.80**	2.10	2.15	2.15	**2.25**
30y	**1.70**	**1.90**	2.20	2.25	2.30	**2.35**

FX forecasts

	Current	4Q18	1Q19	2Q19	3Q19	4Q19
EUR-USD	**1.132**	**1.17**	1.20	1.22	1.23	**1.24**
EUR-GBP	**0.888**	**0.89**	0.91	0.92	0.91	**0.91**
GBP-USD	**1.275**	**1.32**	1.32	1.33	1.35	**1.36**
USD-JPY	**113.3**	**116**	118	120	118	**116**
EUR-JPY	**128.2**	**136**	141.6	146.4	145	**144**

	Current	4Q18	1Q19	2Q19	3Q19	4Q19
NZD-USD	**0.65**	**0.7**	0.7	0.7	0.7	**0.7**
USD-CAD	**1.313**	**1.25**	1.22	1.20	1.20	**1.19**
AUD-USD	**0.71**	**0.7**	0.7	0.7	0.8	**0.8**
EUR-CHF	**1.140**	**1.16**	1.18	1.19	1.20	**1.20**
EUR-SEK	**10.41**	**10.3**	10.2	10.0	9.8	**9.6**
EUR-NOK	**9.56**	**9.3**	9.1	9.0	8.8	**8.7**

Our most recent Macro and Strategy reports and recommendations

Date	Market	Publication	Recommendation	Status	Date closed
30-Oct-18	UK Macro	UK November 2018 Inflation Report Preview: More heat than light?			
30-Oct-18	UK Macro	UK Budget Response, October 2018: OBR's New-Found Optimism Feeds ...			
30-Oct-18	Rates-GBP	Macro Markets Daily-30 October 2018	Buy the OTR 10y gilt (1F 28s) versus its surroundings	Open	
			Buy the OTR 10y gilt (1F 28s) versus 5y (0T 23s)	Open	
26-Oct-18	Rates – EUR	EUR rates going into a tightening cycle: the USD rates precedent			
25-Oct-18	FX	FX Compass - October 2018			
25-Oct-18	Rates – EUR	Periphery EGB exposure: stay long SPGBs and in the BTP box steepener			
24-Oct-18	UK Macro	UK Budget Preview, October 2018: Sticking, not twisting			
19-Oct-18	FX	Bank of Canada still set to hike rates again	Sell NZD/CAD at 0.8640, target= 0.8310, with stop loss at 0.880	Open	
17-Oct-18	Rates – EUR	SPGB Auction Preview: Value in three of the four SPGBs	Switch into the Jul'28 SPGB for the Jan'29 SPGBs	Closed	18-Oct-18
17-Oct-18	Rates - GBP	UK Rates: Brexit scenarios for the coming weeks - Markets are likely to keep ...			
17-Oct-18	FX	Riksbank and Norges Bank to show patience in October			
15-Oct-18	UK Macro	UK Inflation Update: A bump, rather than a fork in the road			
09-Oct-18	Rates – EUR	Portugal set to reopen the Oct'28 PGB			
04-Oct-18	Macro Strategy	Interest & Exchange - Are we there yet?	Pay fixed in 2y USD swaps vs. 2y IL swaps	Closed	31-Oct-18
			5s10s flatteners in USD swaps	Open	
			GBP 2s10s steepener	Open	
			Buy EUR/CHF at 1.1385, target= 1.17, stop loss at 1.1180	Open	
03-Oct-18	Rates – EUR	SPGB Auction Preview: Value in the new Oct'21 and Jul'28 SPGBs	Switch into the Oct'21 SPGB for the Apr'22 SPGBs	Closed	21-Sep-18
01-Oct-18	Rates – EUR	Taking a balanced view on BTPs: Underweight exposure but trade via the term...	BTP-Bund 7y – 20y box spread 'steepening'	Open	
01-Oct-18	FX	USD remains dominant, but CNY reserves rise again			
28-Sep-18	FX	GBP still vulnerable, despite a respectable September			
21-Sep-18	Rates – EUR	USD-EUR rates spreads fully price in policy divergence – there is tightening risk			
21-Sep-19	Rates - GBP	Macro Markets Daily	Sell UKTI 24s on beta-weighted breakeven	Open	
20-Sep-18	FX	FX Compass - September 2018			
19-Sep-18	Rates – EUR	SPGB Auction Preview: The Jan'21 and Jul'28 good for RV trades	Switch into the Jan'21 SPGB for the Jul'21 SPGBs	Closed	21-Sep-18
17-Sep-18	UK Macro	UK Economics: Brexit 'No Deal' - potential routes and risks ahead			
14-Sep-18	FX	NOK – Norges Bank prepares for liftoff			
11-Sep-18	Rates - GBP	UK Auction Preview: New 30y gilt on 11 Sep - 1bp cheap vs. a fitted curve, ...			
11-Sep-18	Rates – EUR	Portugal is to reopen the Oct'23 and Oct'28 PGBs			
10-Sep-18	FX	SEK - No clear winner in Swedish election			
06-Sep-18	Macro Strategy	Tightening, Fast and Slow	Pay 10y Euribor fixed, receive 10y ILS	Open	
			EUR 5s30s 'bearish' flattener	Open	
			Buy SPGB 1.4% Jul-28 vs. Bund 0.25% Aug-2028	Open	
			Pay the belly in 2s7s10s	Closed	4-Oct-18
			Buy EUR/USD at 1.16, target= 1.19, with a stop loss at 1.1450	Closed	9-Oct-18
			Sell GBP/CAD at 1.70, target= 1.65, with a stop loss at 1.7280	Closed	31-Oct-18
05-Sep-18	Rates – EUR	SPGB Auction Preview: tapping the 5y, 10y and 30y SPGBs	Switch into the Jul'23 SPGB for the Jan'23 SPGBs	Closed	6-Sep-18
04-Sep-18	Rates - GBP	UK Auction Preview: 5y gilt on 6 Sep - Attractive RV on a stable curve, with ...	Buy the 1% Apr'24 vs. the 2T Sep'24s	Open	
03-Sep-18	FX	SEK tumbles in August, but reverses in September?	Buy SEK/CHF at 10.64, target 11.20, SL at 10.30	Closed	27-Sep-18
31-Aug-18	FX	CAD - More resilient than expected	Sell USD/CAD at 1.3050, target 1.27, SL at 1.3250	Open	
30-Aug-18	Rates – EUR	Italy risk perception remains elevated – 5y BTPs look cheap in RV	BTP-Bund 5y15y box spread 'steepening'	Closed	
29-Aug-18	Rates GBB	Macro Markets Daily	Sell 2% 20s on RV (2 20s/4 22s flattener)	Closed	31-Oct-18
28-Aug-18	FX	SEK – Election risks, 'Swexit' risks, but no rate hike (yet)			
24-Aug-18	FX	AUD - Another one bites the dust			
23-Aug-18	FX	FX Compass - August 2018			
20-Aug-18	FX	GBP and the Brexit countdown - What's in the box?			
16-Aug-18	Rates – EUR	The widening in periphery EGBs – contagion vs. fundamentals			
15-Aug-18	UK Macro	UK Inflation Response July 2018: All downhill from here			
14-Aug-18	Rates - GBP	Macro Markets Daily	Buy the belly of a 5s7s10s gilt fly (0T 23s/5 25s/1Q 27s)	Open	
13-Aug-18	UK Macro	UK Inflation Update: The calm before the storm?			
09-Aug-18	FX	G10 FX: We know what you said last summer			
08-Aug-18	UK Macro	UK Q2-18 GDP Preview: Separating the wheat from the chaff			
07-Aug-18	Rates - GBP	UK Auction Preview: 10y gilt on 8 August - Local discount may be set ...	Buy 1F 28s vs. 4Q 27s	Open	
			5s10s Gilt ASW flattener	Closed	18-Sep-18
01-Aug-18	UK Macro	UK August 2018 Inflation Report Preview: Once bitten, twice shy			
01-Aug-18	Rates – EUR	SPGB Auction Preview: this summer, we like 3y and 10y SPGBs	Switch into the Jan'21 SPGB for the Apr'21 SPGBs	Closed	2-Aug-18
30-Jul-18	FX	RBA and RBNZ in no rush to hike rates	Sell AUD/NZD at 1.088, target 1.070, SL at 1.100	Closed	7-Aug-18
27-Jul-18	Macro Strategy	Interest & Exchange - Trade Tensions and Curve Inversions	Receive 6m (spot) Sonia OIS	Open	3-Aug-18
			Pay the belly in 2s5s30s - target update	Open	
			Sell GBP/NOK at 10.75, target 10.20, SL at 11.03	Open	
			Sell EUR/SEK at 10.54. target 9.50, SL at 11.06	Closed	27-Sep-18
			Buy NZD/USD at 0.6775, target 0.7400, SL at 0.6463	Closed	5-Oct-18

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G-10 Rates, Macro & FX Strategy

Name	Position	Email	Phone
Antonio Villarroya	Head of Macro & Strategy Research	antvillarroya@gruposantander.com	(+34) 91 257-2244
Luca Jellinek	Head of Rates and FX Strategy	luca.jellinek@santandercib.co.uk	(+44) 33114 80133
José María Fernández	Rates Strategy	josemariafernandezl@gruposantander.com	(+34) 91 257-2244
Edgar da Silva	Rates Strategy	efda@gruposantander.com	(+34) 91 257-2244
Stuart Green	UK Economics	stuart.green@santandercib.co.uk	(+44) 33114 80239
Adam Dent	UK Rates Strategy	adam.dent@santandercib.co.uk	(+44) 33114 80240
Stuart Bennett	G10 FX Strategy	stuart.bennett@santandercib.co.uk	(+44) 33114 80134
Michael Flisher	G10 FX Strategy	michael.flisher@santandercib.co.uk	(+44) 33114 80232
Antonio Espasa	Chief Economist	aespasa@gruposantander.com	(+34) 91 289 3313
Laura Velasco	G10 Economics	laura.velasco@gruposantander.com	(+34) 91 175 2289
Beatriz Tejero García	G10 Economics	beatriz.tejero@gruposantander.com	(+34) 91 257 2176

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).

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

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Local Offices

Madrid	Lisbon	London	Milan
Tel: 34-91-257-2035	Tel: 351-21-389-3400	Tel: 44-870-607-6000	Tel: 39-02-8542-09810
Fax: 34-91-257-0252	Fax: 351-21-387 0175	Fax: 44-20-7332-6909	Fax: 39-02-8606-71648
Brussels	**Paris**	**Frankfurt**	**Caracas**
Tel: 32 2 286 5447	Tel: 33 15353 7000	Tel: 49 6959 67-6403	Tel: 582-401-4306
Fax: 32 2 230 6724	Fax: 33 15353 7060	Fax: 49 6959 67-6407	Fax: 582-401-4219
New York	**Bogota**	**Buenos Aires**	**São Paulo**
Tel: 212-756-9160	Tel: 571-644-8008	Tel: 54114-341-1052	Tel: 5511-3012-5721
Fax: 212-407-4540	Fax: 571-592-0638	Fax: 54114-341-1226	Fax: 5511-3012-7368
Lima	**Mexico DF**	**Santiago de Chile**	
Tel: 511-215-8133	Tel: 525-629-5040	Tel: 562-336-3300	
Fax: 511-215-8161	Fax: 525-629-5846	Fax: 562-697-3869	

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