8 November 2017, 16:30 CET

Interest & Exchange

Steady, as she goes

Global Strategy: The present "short-term recovery, long-term challenges" macro outlook continues to favour a very gradual removal of monetary accommodation. Regarding US monetary policy, for a change, we are now closer to the Fed than to market expectations. On the other hand, after its recent announcement, there is not much uncertainty regarding the ECB in 2018. We think any macro- / US-driven increase in Euro area long-term rates will meet investor demand as yields increase, complementing the ECB's still material gross purchases, slowing down any significant increase in long-term rates.

US Macro: The US economy accelerated in 3Q17 and is likely to keep doing so in the short run. Although inventories and net exports still introduce some volatility in the headline GDP figures, internal demand seems to be ready to grow at rates higher than 2.5% in coming quarters. We believe that private consumption is likely to grow by c.2.5%-3.0% in coming quarters, while business investments could keep surprising on the upside, driving GDP growth above 2.5% in 2018E.

US Rates: Recent macro, fiscal and monetary policy developments can be read as supportive for higher US rates in the medium term. We remain comfortable with our call of higher rates all along the US curve in the quarters to come, with the risks –in our view– now biased towards the uptrend consolidating sooner than we originally expected.

EUR Macro: Domestic demand is increasingly important as a growth engine for the Euro zone. The structural reforms in the labour market, together with the accommodative financial conditions and contention of energy prices, should support the positive growth trend in the coming quarters.

EUR Rates: Faced with still low inflation, the ECB looks set to keep policy looser for longer, while the Fed normalises. The environment for EUR rates is one of low volatility which rewards 'short' trades with negligible or positive carry costs. Periphery news flow has recently been quite supportive and supply should decelerate into year-end. We expect further gains.

GBP Macro: The November meeting brought the Bank of England's first rate hike for a decade, but the market response proved a repeat of August's dovish reaction, encouraged by a strange lack of policy guidance from the MPC. We see little to justify this shift in communication strategy away from policymakers' previous, data-dependent stance, and believe that the MPC could soon be signalling that a faster pace of monetary tightening is likely to be required, risking further market volatility as a result.

GBP Rates: We see current market pricing as insufficient for the risks of tighter directions in both fiscal and monetary policy. We are bearish following the (prematurely) dovish reaction to the BoE's rate hike, and front-end steepeners are our preferred expression. At the far end, we expect a disciplined Budget to help 20-30y gilts outperform on ASW. Ultras have already benefited from a favourable supply/demand balance, and may struggle to perform further on 30s50s.

G-10 FX: The USD should firm as a December Fed hike looms. We are positive the EUR into 2018, but feel that some of the recent gains may have still be overdone. The ECB's policy stance will remain loose and prevent fast EUR gains. The Pound was unimpressed by the BoE rate hike and may again struggle as the economy underperforms and Brexit uncertainty remains.

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@santandergcb.com

Stuart Green
UK Chief Economist
Stuart.Green@santandergcb.com

Adam Dent
UK Rates Strategist
Adam.Dent@santandergcb.com
Banco Santander, S.A. London Branch
(+44) 20 7756-4111 / 6170 / 6223

Stuart Bennett
G-10 FX Strategist
stuart.bennett@santandergcb.com

Michael Flisher
G10 FX Strategist
michael.flisher@santandergcb.com
Banco Santander, S.A. London Branch
(+44) 20 7756- 4136

For a full list of contributors, please refer to page 36

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

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

	USD	EUR	GBP
Economic Outlook	We expect GDP to come in at 2.2% for 2017E, with GDP growth rates at above 2.5% QoQa in 2H17E. Hurricanes and fiscal reform are the main risks to this scenario.	GDP could grow by 2.2% in 2017E (higher than the 2.0% we expected previously). Revisions to previous quarters' numbers would be behind this upside risk.	We expect slow growth through end-2017, as Brexit uncertainty weighs on investment and a real income squeeze hits consumers. We do not see exports as capable of offsetting weaker domestic demand.
Monetary Policy / Front-End	In spite of the start of the b/s reduction, the Dec'17 hike remains on the table. We expect more Fed hikes than the market for 2018.	As expected, the ECB will reduce significantly its bond purchases from Jan'18, but they will continue in the market for almost another 12 months.	We expect Bank Rate to remain at 0.5% through 2018 and no change in QE, but anticipate more hawkish commentary from the MPC in 1H18, driven by concerns around falling spare capacity.
Rates / Duration	Increasing expectations of fiscal easing should maintain the bearish momentum on USTs. We think the market continues to underestimate the pace of FF hikes.	The dovish ECB stance confirms our view that policy rates normalisation will remain ultra-slow, despite robust economic growth, so that term rates will continue to creep higher at the glacial pace set since late 2016.	UK rates of all tenors are now at their lowest since September's MPC meeting, despite the hike being delivered. We are bearish in expectation of hawkish nudges from the MPC.
Curve / Slope	The latest dot chart questions whether the very long end can remain capped by the Fed's "longer-run" projections. 2s10s steepening could continue if macro expectations keep improving.	Curve slope in EUR remains strongly positively correlated to direction. We expect modest steepening.	The whole curve is extremely flat, and 5y in particular is looking vulnerable to renewed pricing for risk. The long end should remain well anchored.
Spreads	Gradually unwinding SOMA reinvestments pose a risk for USTs. We like swap spread wideners (bearish USTs).	Economic recovery and successful financial support by the ECB underpin periphery spreads. Political risk is currently viewed as less of an issue.	Long gilt spreads have been under pressure from speculation of additional borrowing at the Budget .We see this as unfounded, creating a buying opportunity.
Volatility	Recent market changes pushed normalised vols higher, particularly at the top-left corner. However, they still look low vs. delivered, suggesting the trend can continue.	Central banks, especially the ECB, are clearly targeting lower volatility as a priority. Current, low implied vol levels can be sustained over the remainder of 2017.	Implied vols have slumped back after the MPC meeting, to all-time lows for long tenors. This seems unduly complacent given uncertainties around the MPC.
Inflation / Break-evens	Lack of upward pressure on core CPI weighs on front-end BEs, but we expect the upward trend to continue as medium-term expectations (5y5y) remain within the range seen since July.	Though inflation acceleration remains very gradual, 10y ILS levels (1.45-1.5%) near accruing actual inflation (1.4% headline) make long-inflation positions cheap to hold.	UK CPI set to remain around 3% in 4Q17, before decelerating faster than the MPC currently expects in 1H18. Ultra-long linkers look cheap given their light supply.
FX	USD has picked up as the Fed signalled it is on course to hike in Dec 2017. Political issues are still a worry, but yields should keep the USD firm.	The EUR/USD uptrend that began in May seems to have ended. The pair should edge lower into the end of the year as risk eases and the Fed hikes.	A dovish hike by the MPC provided no GBP support. Domestic politics is again dragging on the Pound. Plus, Brexit uncertainty is still expected to weigh on the economy and GBP in 2018.
Main Risks (to our views)	Sizeable deceleration of Chinese economy. EM assets' reaction to the Fed's initial adjustment, in a structurally more illiquid market.	Even after the French presidential election, political, economic and financial uncertainty remains relatively high, with 'risk' markets priced for a continuation of the positive trend.	MPC resumes hawkish policy guidance. Escalating gridlock within the government or Brexit negotiations. Unexpected acceleration in wages.

Source: Santander Economics, Rates and FX Strategy Research. For a full list of contributors, please see contact details on page 36.

Global Strategy: (Very) Gradual Removal

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

- **The present "short-term recovery, long-term challenges" macro outlook continues to favour a very gradual removal of monetary accommodation. Regarding US monetary policy, for a change, we are now closer to the Fed than to market expectations. Across the Atlantic, after its recent announcement, there is not much uncertainty regarding the ECB in 2018.**
- **We think any macro- / US-driven increase in Euro area long-term rates will meet investor demand as yields increase, complementing the ECB's still material gross purchases, thus slowing down any significant increase in long-term rates.**

Table 1: GDP growth expectations – IMF forecasts and changes

	Forecasts			vs. July	
	2016	2017	2018	2017	2018
World	3.2	3.6	3.7	0.1	0.1
Advanced	1.7	2.2	2	0.2	0.1
US	1.5	2.2	2.3	0.1	0.2
Euro Area	1.8	2.1	1.9	0.2	0.2
Germany	1.9	2.0	1.8	0.2	0.2
France	1.2	1.6	1.8	0.1	0.1
Italy	0.9	1.5	1.1	0.2	0.1
Spain	3.2	3.1	2.5	0.0	0.1
Japan	1.0	1.5	0.7	0.2	0.1
UK	1.8	1.7	1.5	0.0	0.0
Emerg Ec.	4.3	4.6	4.9	0.0	0.1
Russia	1.8	1.6	0.4	0.2	0.4
Emrg Asia	6.4	6.5	6.5	0.0	0.0
China	6.7	6.8	6.5	0.1	0.1
India	7.1	6.7	7.4	-0.5	0.3
Emrg Eur	3.1	4.5	3.5	1.0	0.3
Latam	-0.9	1.2	1.9	0.2	0.0

Source: IMF, Santander

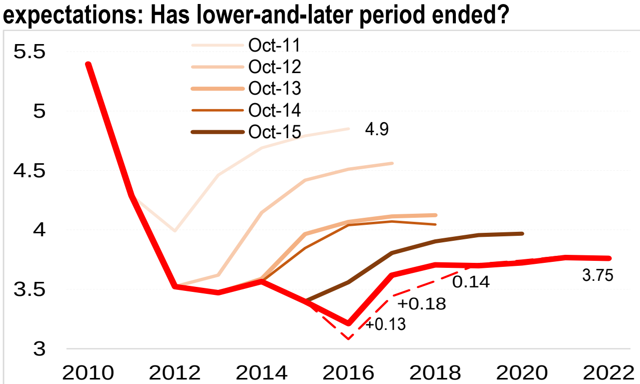
Macro-wise, there have not been many surprises lately as advanced economies continue growing at a healthy pace, and without any worrisome underlying inflationary pressures. Yet, helped by the still very loose monetary policy –despite the BoE recently joining the Fed's tightening club–, fiscal policy can also play a role in coming months, as the eagerly-awaited US tax reform becomes more likely, even if in a very watered-down form.

In this connection, we found the IMF's latest Global Economic Outlook interesting. Although it does not normally differ much from the market consensus, for the first time in years expected global growth was revised upwards after growth expectations had been sequentially postponed over the last six years, with the terminal (long-term) growth rate revised lower. As seen in Chart 1, 2017-2019 Global Real growth expectations were raised, albeit moderately (+0.13%/+0.18%) and these revisions do not reach the longer-term horizon (2020 and beyond), when growth is expected to stabilize well below pre-crisis levels.

The other aspect we found interesting –something that relates to our comments in these pages last month– is the synchronicity of this recovery. In our latest I&E, we highlighted that all OECD countries were expected to grow both this year and the next. That is also the case for the IMF. Moreover, the Fund also sees the gap between the fastest- and slowest-growth advanced economies continuing to fall significantly, while the standard deviation of all these countries' growth has not only reached its lowest point this year, but is also expected to keep on falling until 2020 (Chart 2).

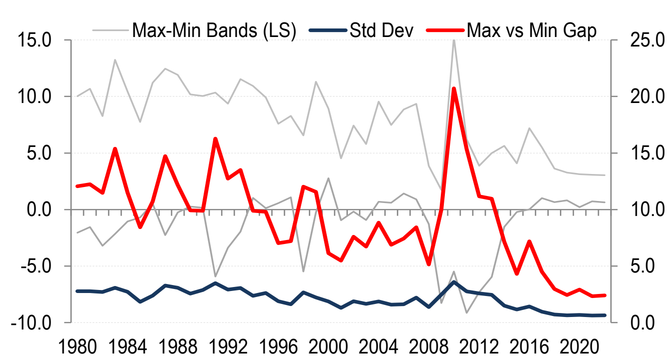
This environment of increasingly reduced macro uncertainty obviously supports the significant decline in financial markets' volatility.

Chart 1: Global GDP growth: Actual and historical expectations: Has lower-and-later period ended?



Source: IMF, Santander

Chart 2: Advanced economies highest vs. lowest- growth economies (level and gap) and standard deviation



Source: IMF, Santander

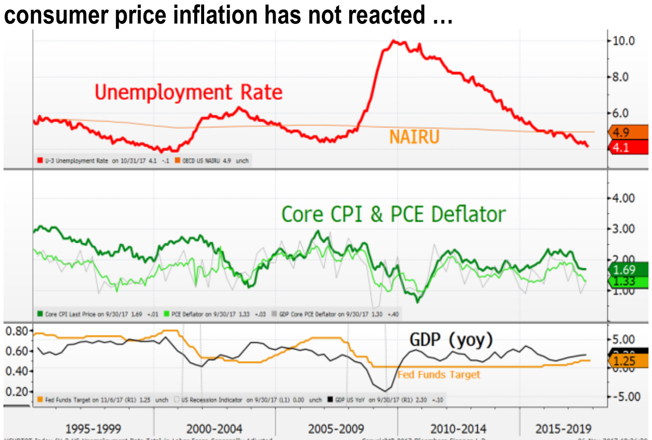
The IMF's "short-term recovery, long-term challenges" theme is therefore not too dissimilar to our long-held "cyclical upswing amid structural headwinds" view. We believe this will continue, to a large extent affected by the still very loose monetary policy, but it will also make this removal of excess liquidity a very gradual process.

The Fed's on a mission, regardless of who's in charge

As universally expected, the US Federal Reserve did not take any decision to change either official rates or the already-announced balance-sheet reduction path when the FOMC met earlier this month. Yet its statement cemented – barring unexpected events– another instalment of its gradual removal of the excessive monetary accommodation at its 13-December gathering.

Bearing in mind that the Fed's statement acknowledged that "inflation remains soft", the likely 25bp hike next month should be seen as simply following its own expected path of gradual hikes, with the economy evolving in line with expectations, rather than an extra move. To us, the key part reflecting the members' confidence in the current economic outlook is the "upgrade" of their characterization of the economic activity from it "*has been rising moderately*" to it "*has been rising at a* ***solid rate*** despite hurricane-related disruptions".

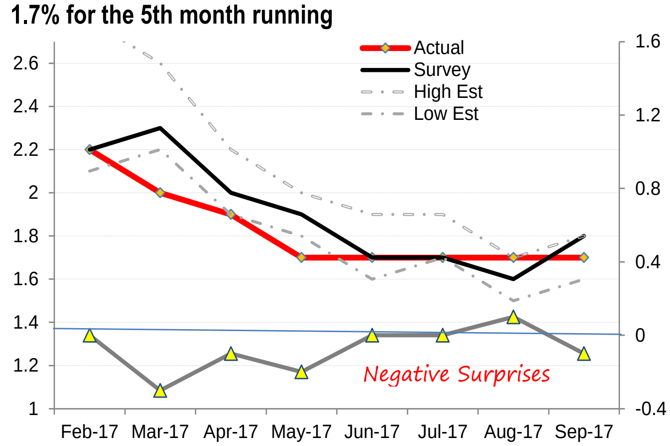
Chart 3: US growth and labour market improving, but consumer price inflation has not reacted ...



Source: OECD, Santander

, Bloomberg

Chart 4: ... and core CPI disappointed again in September, at 1.7% for the 5th month running



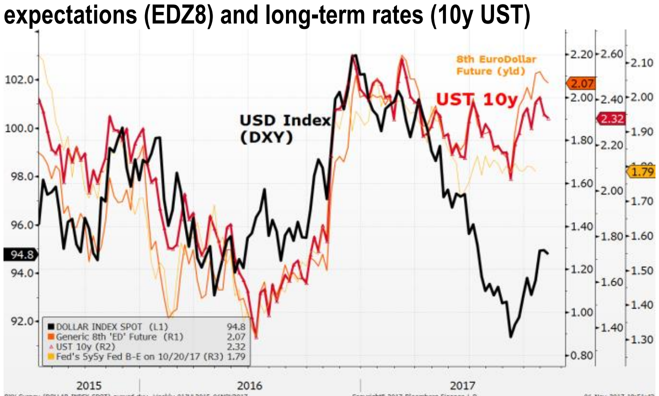
Source: OECD, Santander

Janet's last instalment

For the last meeting of the year (13-Dec), as seen in the September FOMC dot plot and meeting minutes, a majority of Fed members consider that, if the US economy continues progressing as expected, another 25bp hike would be warranted, after skipping the 2017 quarterly hike in September.

Although consumer price pressures have been mixed –CPI and PCE price indicators remaining subdued, but ECI strengthened– we expect the Fed to hike by another 25bp (the fifth hike in this cycle, and Yellen's last) next month. However, we will also be paying close attention to the macro and official rate forecasts published in that meeting, as the actual hike is unlikely to be a big market mover given that it is widely priced in (Table 2).

Chart 5: USD trade-weighted index (DXY) vs. official rate expectations (EDZ8) and long-term rates (10y UST)



Source: Bloomberg, Santander

Table 2: Market implied Fed Funds probabilities

FOMC Meeting date	fwd eff FF	Probability of 25bp changes			
		0	1	2	3
Dec 13, 2017	1.37%	4%	96%	-	-
Jan 31, 2018	1.41%	-	88%	12%	-
Mar 14, 2018	1.49%	-	56%	44%	-
May 02, 2018	1.52%	-	44%	56%	-
Jun 13, 2018	1.60%	-	12%	88%	-
Jul 25, 2018	1.65%	-	-	92%	8%
Sep 19, 2018	1.67%	-	-	84%	16%
Oct 31, 2018	1.72%	-	-	64%	36%
Dec 12, 2018	1.73%	-	-	60%	40%
Jan 30, 2019	1.73%	-	-	60%	40%

Source: Bloomberg, Santander

Going further: Steady, as she goes

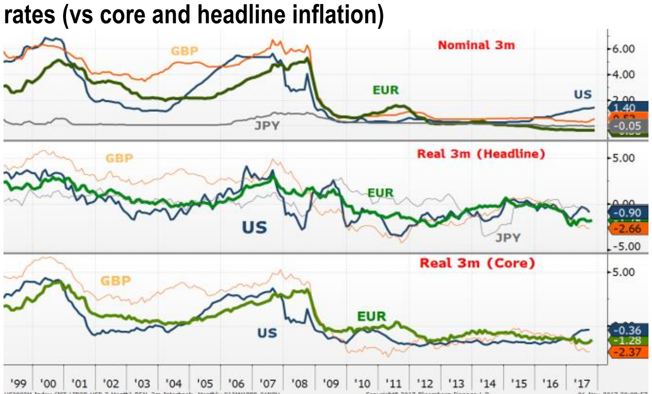
Betting on a slightly more hawkish Fed in 2018 (than priced in by the market)

Two months ago, we recommended the 98.125-97.875 EDZ8 Put Spread, fully funded by selling the 98.5 Call (@ zero cost). We now take profits (7.5bp) and move to the 98.00-97.75 PS vs 98.25 Call (also zero cost), see Chart 7.

Looking ahead to next year, for a change, we are closer to the Fed's than to the market's expectations for monetary policy. Helped by the possible (albeit moderate) fiscal easing around the year-turn, the USD's 2017 decline, gravity-defying asset prices and the possible reaction of wage settlements to the increasingly tight labour market, **we think the Fed is likely to hike rates at least twice, and most likely three times, in 2018**. Yet, according to our models, once we include the Fed's balance sheet expansion, the Fed's *QE-adjusted official rate* will only become 'positive' by 2021. And in real terms, short-term rates are still clearly stimulative by historical standards (Chart 6).

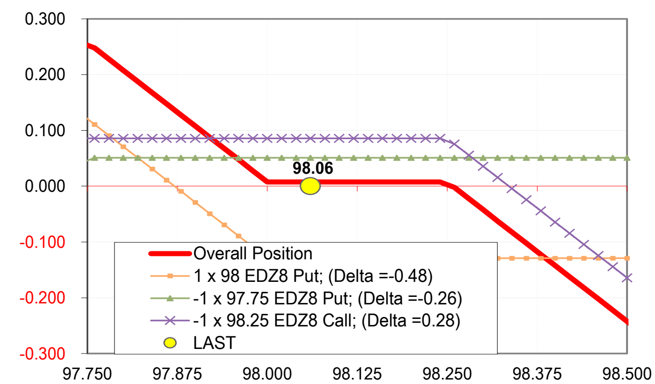
Our Fed call is therefore more hawkish-than-current market pricing (1.4 hikes in 2018), although it is difficult to have a very clear view given the lack of visibility about the Fed's composition in 2018. In any case, we do not expect the change in leadership to, per-se, result in a notably more hawkish/dovish Fed compared to the last four years under Janet Yellen. **We continue to see value in front-end steepeners and slightly OTM payer spread structures in short-term tenors or EDZ8 contracts. See margin and Chart 7**.

Chart 6: US, EUR and GBP nominal and real short-term interest rates (vs core and headline inflation)



Source: Bloomberg, IMF, Santander

Chart 7: Dec'18 EuroDollar put spread (vs call)



Source: Bloomberg, Santander

BOE 'one and done' vs. an immutable BOJ?

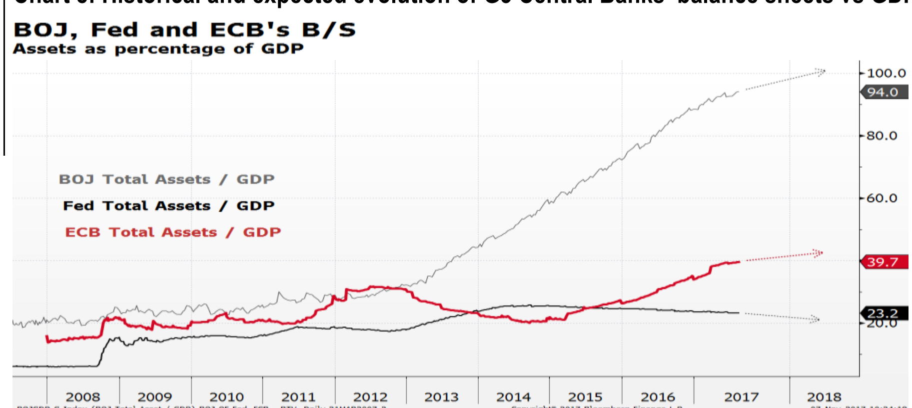
As detailed in the UK economics section, regarding the BoE's monetary policy, the market seems to have moved much closer to our 'one-and-done' hike expectations as we think a substantial part of the recent economic –and inflation – data has been affected by the GBP's post-Brexit decline, which looks far from correcting despite the change in monetary policy. At the same time, the BoJ maintained its balance sheet extension program unchanged in its recent meeting, also retaining the 'yield control' aspect that helps keep 10-year JGBs trading close to zero (+2.5bp at the time of writing), with implications for global rates given these cross-market flows.

Table 3: Market implied BoE probabilities

MPC Meeting date	fwd MPC	Probability of 25bp changes: -1	0	1	2
Dec 14, 2017	0.50%	0%	100%	-	-
Feb 08, 2018	0.54%	-	84%	16%	-
Mar 22, 2018	0.54%	-	84%	16%	-
May 10, 2018	0.61%	-	56%	44%	-
Jun 21, 2018	0.62%	-	52%	48%	-
Aug 02, 2018	0.69%	-	24%	76%	-
Sep 13, 2018	0.69%	-	24%	76%	-
Nov 08, 2018	0.73%	-	8%	92%	-
Dec 20, 2018	0.74%	-	4%	96%	-
Feb 14, 2019	0.76%	-	-	96%	4%
Mar 28, 2019	0.78%	-	-	88%	12%
May 23, 2019	0.79%	-	-	84%	16%

Source: Bloomberg, Santander

Chart 8: Historical and expected evolution of G3 Central Banks' balance sheets vs GDP



Source: Bloomberg, Santander

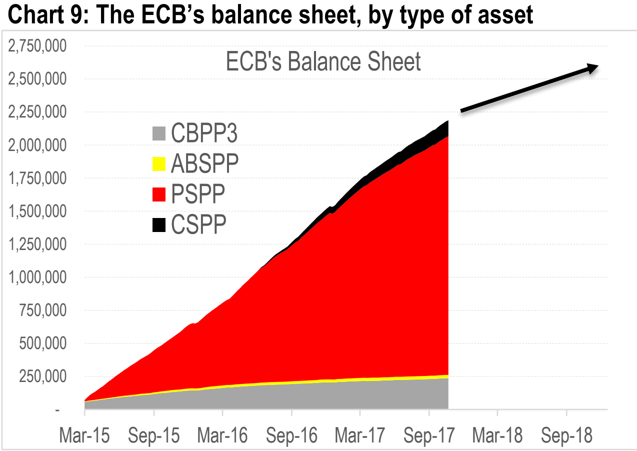
ECB: Done and dusted (no more surprises left)?

ECB's bond portfolio
€2,187bn @ 31-Oct
*+€120bn; €60bn * 2 (Nov-Dec17)*
*+ €270bn; €30bn * 9 (Jan-Sep'18)*
+ €20bn; €20bn+€10bn (Oct-Nov18)
= €2.6trn @ Dec'18.

After the ECB's recent announcement about extending its asset purchase program (APP) from next January (at half its current pace), there is now very little uncertainty left regarding most aspects of its QE. Indeed, the only remaining uncertainties are: (i) whether these purchases will face a final slowdown from €30bn to zero in 4Q18 (according to Draghi the APP "is not going to stop suddenly"); and (ii) the actual breakdown of the €30bn, as we think the reduction will be more than proportional in government bonds, especially in Germany, with a much smaller reduction in credit paper. On the other hand, we believe Euro zone macro conditions in 2018 will make another APP extension unlikely. Accordingly, we now have a much clearer view on the:

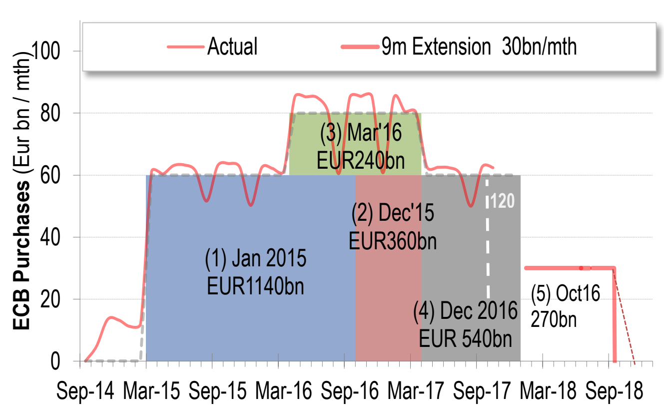
1. Total size of the ECB bond (APP) portfolio: c.€2.6trn by the end of next year. Its current size is c.€2.2trn, with €1.8trn in PSPP (82%) vs. €122bn in corporates and €236bn in covered bonds (Chart 9).
2. Total size of the ECB's balance sheet. It will reach c.€4.8trn (41% of GDP) and is unlikely to start declining until the TLTROs mature, although prepayments can start from September 2018. This balance sheet size is significantly larger than the Fed's and the BoE's when compared to the size of these economies, as they represent c.20% and 15%, respectively, of US and UK GDP

Chart 9: The ECB's balance sheet, by type of asset



Source: Bloomberg, Santander

Chart 10: ECB APP Purchases (amount per month vs time)

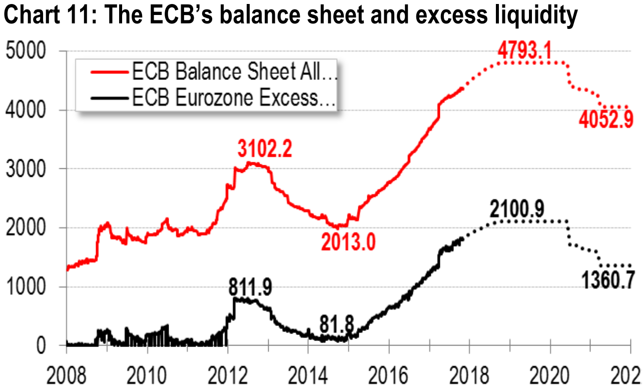


Source: Bloomberg, Santander

3. Bond purchases: In 2018, the ECB will buy another €270-300bn under its APP. Given the potential scarcity problem in some countries, mainly Germany, and despite the 50% reduction in total purchases, we think the decline will be more than proportional in government bonds, and significantly smaller in corporate paper (see margin). Of this €290bn (assuming a small tapering in 4Q18), we think less than 50% will go to EUR govies. Yet this c.€160bn in purchases is not significantly smaller than the expected net supply of govies in 2018

"… we will continue buying sizeable quantities of corporate bonds in the programme and then you get the rest."
Mario Draghi Oct'17

Chart 11: The ECB's balance sheet and excess liquidity



Source: ECB, Santander

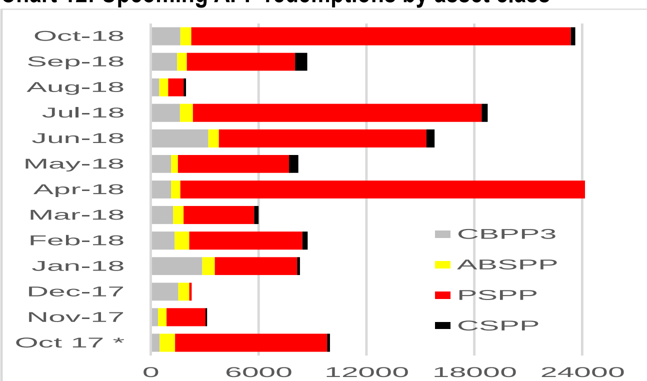
Table 4: The ECB's APP by asset class – Historical vs. proportional and expected decline

	Historical data, EUR bn				Proport.		Forecasts		
	Avge Jun'16-Mar'17	% of total	Avge since Apr'17	% of total	Scenario 1	% of total	Scenario 3	% of total	% chg vs 60
EAPP target	**80.0**	**100%**	**60.0**	**100%**	**30.0**	**100%**	**30.0**	**100%**	-50%
CSPP	7.7	10%	6.6	11%	3.3	11%	5.5	18%	-17%
CBPP3	3.9	5%	3.0	5%	1.5	5%	2.5	8%	-16%
ABSPP	0.5	1%	0.0	0%	0.0	0%	0.0	0%	0%
PSPP	**67.8**	**85%**	**50.4**	**84%**	**25.2**	**84%**	**22.0**	**73%**	-56%
Supras	6.8	8%	5.1	8%	2.5	8%	3.0	10%	-41%
Countries	61.1	76%	45.3	76%	22.7	76%	19.0	63%	-58%
Agencies *	9.2	11%	6.8	11%	3.4	11%	4.0	13%	-41%
Govies *	**51.9**	**65%**	**38.5**	**64%**	**19.3**	**64%**	**15.0**	**50%**	-61%
Germany	16.7	21%	11.6	19%	5.8	19%	4.5	15%	-61%
Bunds **	**12.8**	**16%**	**8.0**	**13%**	**4.0**	**13%**	**2.9**	**10%**	-64%
Spain	8.3	10%	6.0	10%	3.0	10%	2.4	8%	-61%
SPGBs *	**7.1**	**9%**	**5.1**	**9%**	**2.6**	**9%**	**2.0**	**7%**	-61%

Source: ECB, Santander

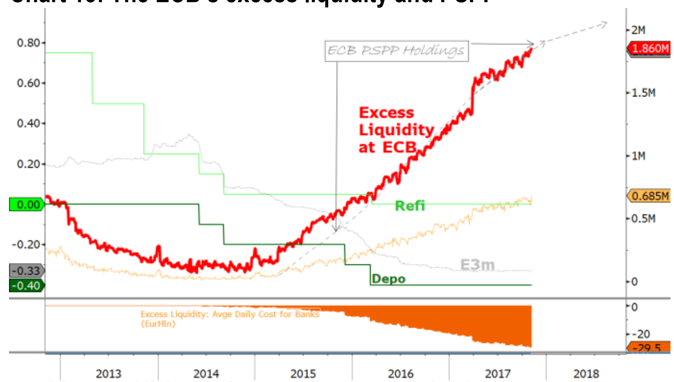
4. In the case of **Germany**, net purchases will decline from the current €11.6bn per month to c.€4.5bn in net terms, or above €6bn in gross terms (i.e., taking into account 2018 redemptions, Chart 12).
5. In the case of **Spain**, we expect the BoS purchases to decline from the current €5bn to c.€1.8bn per month in net terms, but to be close to €3bn in gross terms. Total gross purchases in 2018 would therefore be c.€35bn, very similar to the annual net supply of SPGBs next year.
6. Given its relationship with the PSPP, excess liquidity in the Euro area (currently €1.8trn) is likely to rise further and top €2trn in 1H18. So, it would keep putting downward pressure on short-term rates.

Chart 12: Upcoming APP redemptions by asset class



Source: Bloomberg, Santander

Chart 13: The ECB's excess liquidity and PSPP



Source: Bloomberg, ECB, Santander

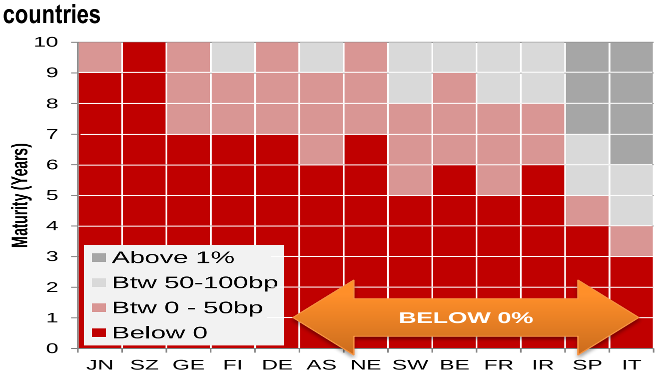
Some implications for interest rates:

a) Regarding the short end, in spot terms, 3m and 6m Euribor have already stabilized (at -33bp and -27bp respectively). But 12mth Euribor could fall further (to -20bp) in coming months, and is unlikely to become positive again until 2019.

b) As for official rate expectations, we believe Draghi succeeded focusing on forward guidance, and convincing the market the ECB will remain on hold until around mid-2019. It therefore took some steam off the EUR, as expected. Our view here does not differ significantly from the market's now.

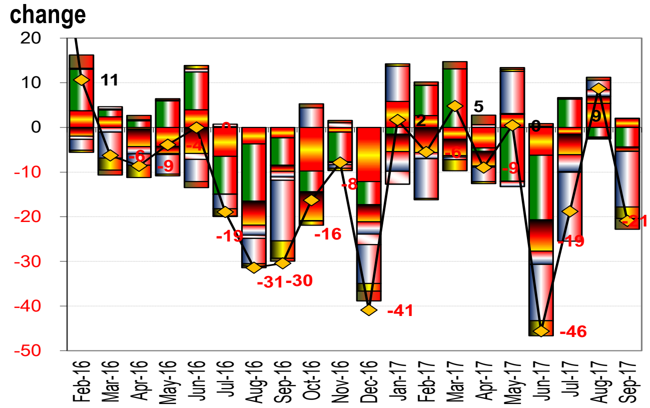
c) In the long end, although we should have left the yield lows behind, with so much excess liquidity floating around –and here to stay–, so few opportunities to find reasonably high-quality yield globally (Chart 14) and European ALMs having significantly reduced their balance sheets (Chart 15), we think any macro-/US-driven increase in Euro area long-term rates will find investor demand as yields increase. And this should complement the ECB's still material gross purchases, slowing down any significant increase in long-term rates

Chart 14: Government yield vs. bond maturities in NIRP countries



Source: Bloomberg, Santander

Chart 15: Euro area banks' holdings of EUR govies, monthly change

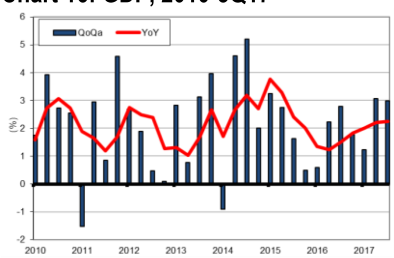


Source: Bloomberg, ECB, Santander

Antonio Espasa
(+34) 91 289 3313

The US economy accelerated in 3Q17 and is likely to keep doing so in the short run. Although inventories and net exports still introduce some volatility in the headline GDP figures, internal demand seems to be ready to grow at rates higher than 2.5% in coming quarters. We believe that private consumption is likely to grow by c.2.5%-3.0% in coming quarters, while business investments could keep surprising on the upside, driving GDP growth above 2.5% in 2018E.

Chart 16: GDP, 2010-3Q17

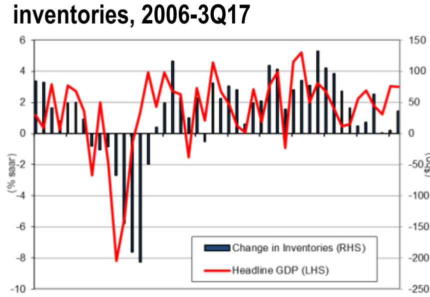


Source: Datastream and Santander.

Chart 17: GDP vs. private domestic final sales, 2010-3Q17

Source: Datastream and Santander.

Chart 18: GDP vs. change in inventories, 2006-3Q17



Source: Datastream and Santander.

The US economy accelerates in 3Q17

The release of 3Q17 GDP figures showed that the US economy is performing well. Far from being stagnant in 3Q17, which might have been expected after the big hurricanes and storms, the US economy posted another strong quarterly growth rate, basically maintaining the same pace as in the previous quarter and pointing to a similar rate in the final quarter of the year. US GDP grew by 3.0% QoQ annualised in 3Q17, from 3.1% QoQa in the previous quarter, pushing the annual growth rate to 2.3%, which is the highest since 3Q15 (2.4%). According to our estimates, the US economy could grow by 2.2% this year, which would imply another c.3.0% QoQa growth rate in 4Q17E. Moreover, we believe that 2018E GDP growth rates should exceed the 2.5% level.

Internal demand keeps doing very well, with volatility coming from net exports and the inventory component

Interestingly, the performance of internal demand has been better than that of the headline GDP in recent quarters, despite being slightly weaker in both 2Q17 and 3Q17. The volatility of headline GDP is basically due to the inventory and net exports components.

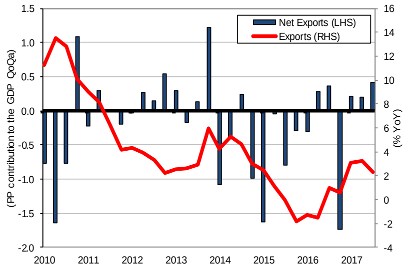
The inventory component trimmed 0.4pp off GDP growth in 2016, after having added 0.2pp in 2015. Quarterly volatility has been quite high, with a positive contribution of 1.1pp to the QoQa GDP growth rate (1.8%) in 4Q16, following a negative one of 1.5pp to 1Q17's 1.2%, an almost flat reading in 2Q17 and a positive 0.7pp contribution to 3Q17 GDP growth. Moreover, the change in inventories dropped from $106bn in 2Q15 to just $1.0bn in 1Q17, before growing to $36bn in 3Q17. That is, companies have cut activity sharply since 2H15 in order to reduce their stock piles, possibly concerned about future demand. This process slashed inventories to almost zero at the beginning of this year. Then, the acceleration of final demand, both internally and externally, pushed companies to start producing strongly again in order to meet final demand. In our view, this process has just started, and we should see further inventory accumulation in coming quarters, which should help GDP growth rates to accelerate going into 2018.

Net exports were also among the components introducing volatility in the headline GDP growth rates. They have made a negative contribution to GDP growth since 2014 (-0.1pp), and were a particular drag in 2015 (-0.7pp), then slightly less so in 2016 (-0.2pp). The deterioration of global trade was the main culprit behind the negative performance in 2015, as it coincided with US internal demand performing very well, which resulted in weak exports (0.4%) and still strong imports (5.0%). Since then, we have seen how global trade has been improving and is now growing strongly, which would explain the improvement in US exports (-0.3% in 2016 and c.3.0% in 2017E). We expect net exports' contribution to GDP growth to be slightly negative (-0.2pp) in both 2017E and 2018E.

The volatility shown by those two components has somewhat overshadowed the good performance of US internal demand in recent quarters. In terms of final sales, annual growth rates have been above the 2.0% mark since 1Q17, while annual GDP growth could reach 2.4% in 2017E from 1.9% in 2016, both of which would outstrip the GDP growth rates for both years.

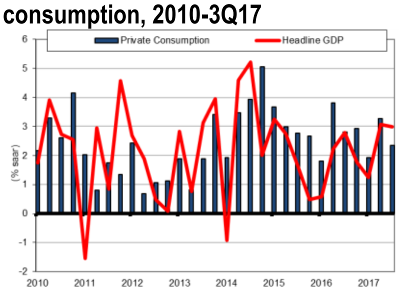
If we exclude net exports, to look at the performance of domestic final sales, we find that they have actually outstripped final sales since 2015. They rose by 3.3% in 2015 (vs +2.9% for GDP) and by 2.1% in 2016 (vs GDP at +1.5%). Moreover, we expect them to grow by 2.4% in 2017E.

Chart 19: GDP-exports vs. net exports' contrib. to GDP growth, 2010-3Q17



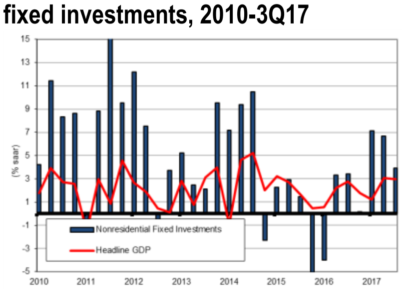
Source: Datastream and Santander.

Chart 20: GDP vs. private consumption, 2010-3Q17



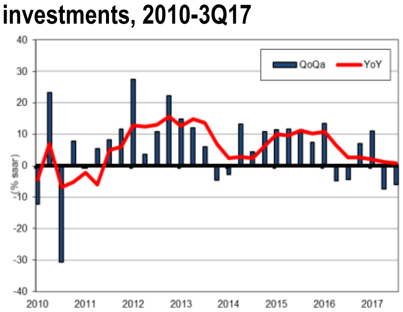
Source: Datastream and Santander.

Chart 21: GDP vs. non-residential fixed investments, 2010-3Q17



Source: Datastream and Santander.

Chart 22: GDP vs. residential investments, 2010-3Q17



Source: Datastream and Santander.

Lastly, private domestic final sales performed even better: 3.7% in 2015, 2.4% in 2016 and 3.0% expected for 2017E. This clearly highlights the strength of private internal demand, which we believe can grow at sustainable levels of between 2.5% and 3.0%.

Private consumption sustaining c.2.5% growth rates, while business investments seem to be picking up again on a sustainable basis

Both private consumption and business investments seem to be holding up relatively well going into 4Q17. In fact, the performance of business investments is quite reassuring, given the weakness observed in 2016. Going into the details of both, we find that:

1. Private consumption grew by 2.4% QoQa in 3Q17, which is below the level reached (3.3% QoQa) in 2Q17, but higher than the 1.9% QoQa posted in 1Q17. Recent numbers have implied a deceleration in the annual growth rates of private consumption, to around 2.5% in 3Q17 from 2.9% in 1Q17. In our view, households' fundamentals are strong enough to support private consumption growth rates of c.2.5% on a sustainable basis, but are probably not strong enough to maintain private consumption growing at 3.0% levels. Households have been using not just income, but have been eating into the generation of savings in order to finance the current level of consumption. That is, without having reduced the savings rate, households would not have been able to maintain private consumption growth at 2.7% in 2017E. In any case, as we explained in one of our recent Interest & Exchange documents, we are not concerned about this decline in the savings rate, given the strength of the balance sheet, with net wealth at the highest level ever, both in absolute terms and in relation to gross disposable income.

2. On the investment side, we saw another significant increase in business investments in 3Q17, while residential investments did quite the opposite, falling again. Fixed investments rose by 1.5% QoQa in 3Q17, after two quarters of strong growth (3.2% QoQa in 2Q17 and 8.1% QoQa in 1Q17), with the main driver being non-residential investments, which rose by 3.9% QoQa in 3Q17 after advancing 6.7% QoQa in the previous quarter. Although the volatile component of business structures has fluctuated sharply since 1Q17, for us the most interesting performance is that of business equipment, which has improved significantly since last year. Investments in equipment fell for four quarters in a row over 4Q15-3Q16, but have been growing since then. In fact, they have accelerated quite sharply (4.4% QoQa in 1Q17, 8.8% in 2Q17 and 8.6% in 3Q17). According to our forecasts, investments in equipment could grow by c.4.0% in 2017E. The performance of capital goods orders in recent months and that of leading business confidence indicators point to a continuation of the strong growth rates in business investments in 4Q17E and onwards. On the contrary, residential investments have fallen sharply in the last two quarters, and we would expect some improvement in 4Q17E and 1Q18E.

US Rates Strategy: And here comes the fiscal easing

José María Fernández
(+34) 91 257 2244

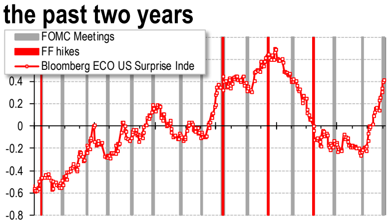
- **The introduction of the "Tax Cuts and Jobs Act" will translate into higher funding needs for the US Treasury in the years ahead, in a context where one of the main UST buyers (the Fed) will gradually be stepping back from the market. Additionally, the implied fiscal easing should boost expectations that nominal growth will improve again in the US.**
- **In this environment, the Fed remains committed to hiking official rates again before the end of the year, as confirmed (in our view) by the November FOMC statement.**
- **All things equal, the combination of these factors represents an upside risk for UST yields in the medium term and leaves us comfortable with our bearish call on USTs. But we now believe the uptrend might consolidate sooner than we were originally expecting – and we reflect that in our updated forecasts. We now think US rates could breach their 2017 highs, all along the curve, as soon as 1Q18**

Recent developments pave the way for higher US rates

Since we published the previous edition of this report, **developments on the macro, fiscal and monetary policy fronts can be seen as supportive for higher rates in the US in the medium term**. Not surprisingly, US rates refreshed their 2H17 highs as recently as the end of October in the belly and long end of the curve, while front-end rates keep increasing at a healthy pace. While some volatility is possible (and we assess the recent correction in the belly and long end as part of it), these developments **leave us comfortable with our call of higher rates all along the US curve in the coming quarters**, with the risks –in our view– now biased towards **the uptrend consolidating sooner than we were originally expecting**.

On the **macro front**, the data published since the end of September have so far consistently surprised to the upside. Indeed, Bloomberg's Economic Surprise Index shows a decent recovery for the US economy, and is now back at levels similar to those posted between Dec'16 and May'17 (see Chart 23). As discussed in detail in the US Economy section, the negative impact of the hurricanes has been relatively limited, will probably be short-lived and, we believe, will likely drive a significant pick-up in activity in the coming months. Just to mention some recent examples, the first estimate of 3Q17 GDP was clearly stronger than anticipated, while leading indicators such as the ISM or the PMIs remain at levels not seen since 2011, pointing to strong industry growth in the quarters to come. And the growth rates in personal income and spending, as well as in productivity, are also encouraging.

Chart 23: US economic surprises over the past two years

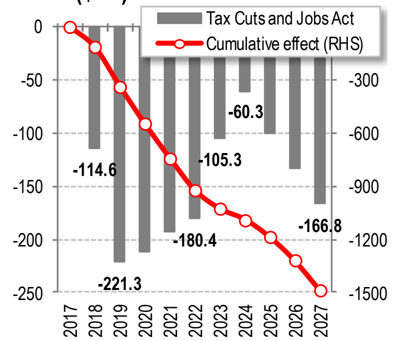


Source: Federal Reserve, Bloomberg, Santander.

But **it is not just the data surprising to the upside**. The introduction of the "Tax Cuts and Jobs Act", apart from its fiscal implications (that we comment on below), should be supportive for US nominal growth in the years to come. Independent studies, such as that published by the 'Tax Foundation', suggest that it could boost GDP by 3.9% over the long term. While the final impact of these measures will not be seen immediately, we believe that the fiscal reform might represent an **inflection point in the expectations component**. After several months of growth and CPI consensus estimates being revised to the downside in the US (the reflation deflation trade), we believe that the prospects of some fiscal stimulus for the US economy should now help consolidate an upward trend in these revisions, although it might fall short of the disproportionate optimism that followed the US elections, a year ago.

The flip side of **the fiscal reform** is that it will increase the US Treasury's funding needs in the years to come. The estimated revenue effects of the fiscal reform, as detailed by the Joint Committee on Taxation, indicate that the net total impact of all the measures included in the tax reform will add up to $1.5trn between now and the end of 2027, with a good part of that extra funding frontloaded in the first years of the programme (see Chart 24). And that **should translate directly into an increase in the US Treasury's net issuance in coming years**.

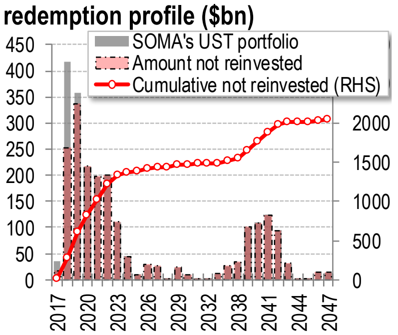
Chart 24: Net total impact of estimated "Tax Cuts and Jobs Act" revenue effects ($bn)



Source: US Congress' JCT, Santander.

This is particularly important **in the current environment, with the Fed already having started to shrink the size of its balance sheet** by gradually scaling back the reinvestments from its SOMA redemptions, as this has an **additive effect that might alter the UST supply/demand equilibrium**. As explained in detailed in the 1 September edition of this report, the amount of USTs the Fed will stop reinvesting could add up to around $1trn over the next four years (see Chart 25), while the US Treasury's funding needs will increase by as much as c.$750bn during that same period, due to the fiscal reform. As a result, **the US Treasury will need to find "new" demand for as much as c.$1.75trn of USTs in the next four years** just to maintain the current supply/demand equilibrium. In our view, this could imply a risk of some upward repricing in UST yields in the quarters ahead.

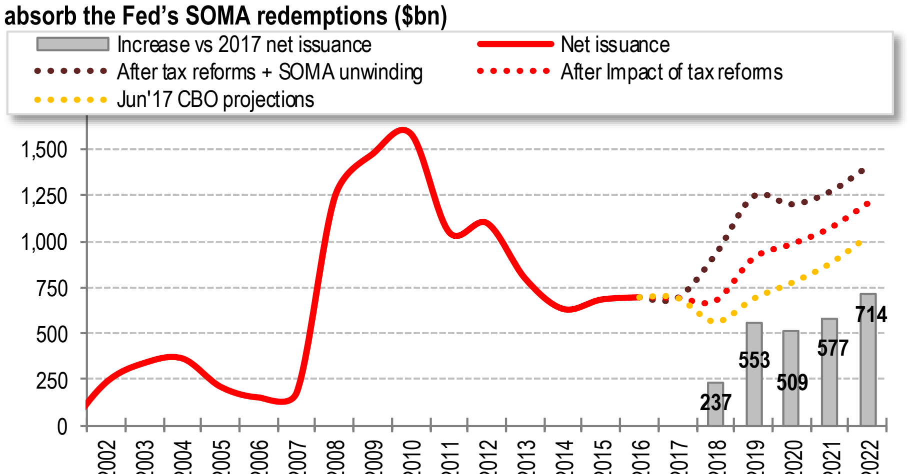
Chart 25: SOMA's UTA portfolio – redemption profile ($bn)



Source: Federal Reserve, Bloomberg, Santander.

In Chart 26 we illustrate the impact of this extra net supply by comparing it to the latest CBO projections, published in June (yellow dotted line). The increase in funding needs from the fiscal reform (red dotted line) should translate into net funding remaining at current levels in 2018 (at around $700bn per year, while the CBO projections suggested a slight decline to below $600bn). If we add the impact of the Fed's SOMA unwinding (brown dotted line), **the equivalent net issuance for 2018 would increase to c.$1trn and, from 2019, annual net issuance would almost double the figure seen in 2017**.

Chart 26: Expected net issuance of USTs, with fiscal reform, and extra demand needed to absorb the Fed's SOMA redemptions ($bn)

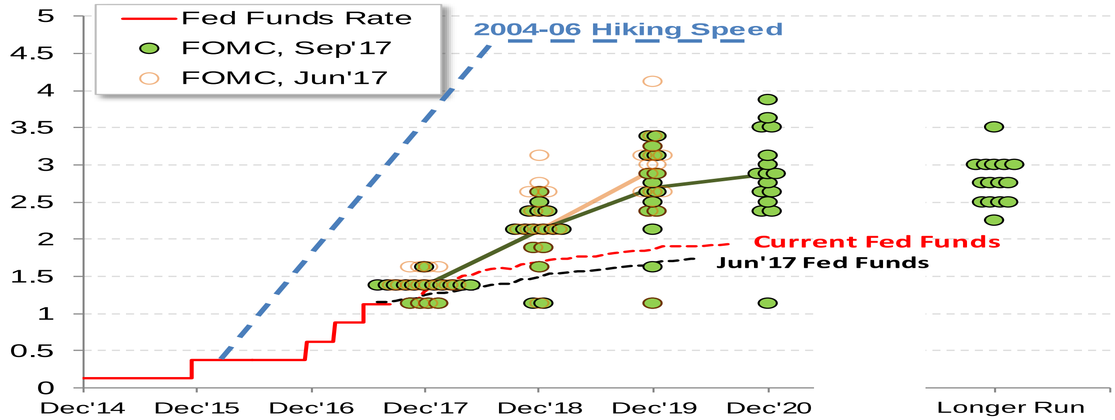


Source: US Congress' JCT, Santander.

Last, but not least, we must not forget that US **monetary policy** will gradually become less accommodative. The Fed is embarked on a series of rate hikes that, after a temporary break in September (when the FOMC focused on the balance-sheet reduction measures), could resume as soon as the next meeting. As we discussed in our post-mortem analysis of the latest FOMC decision, published in our 2 November MMD, November's official statement included a sanguine assessment of the economy which, in our view, suggests that **the FOMC members are still comfortable with delivering the 25bp hike** most of them **already pencilled in for December** in September's Summary of Economic Projections.

We continue to see some risks further out, as we believe **the market is still underestimating the pace of hikes in the coming quarters**, especially now that the fiscal reform is on the table. We expect the Fed to be able to deliver most of the tightening already reflected in its dot chart (see Chart 27). Therefore, we think **the Fed is likely to hike rates at least twice, and probably three times, in 2018**, while the market is only factoring in one-and-a-half hikes for that period.

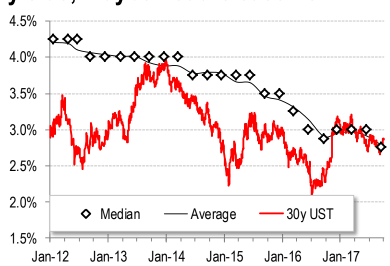
Chart 27: September 2017 FOMC dot chart vs. current FF futures



Source: Federal Reserve, Bloomberg, Santander.

Also interesting, and as explained in detail in our [1 September I&E], the latest dot chart revealed that most FOMC members see the FF rate reaching above "longer-run" levels. Previously, it was a common-held market belief that these longer-run dots represented the terminal rate the FOMC members were projecting for the current tightening cycle, and **we have seen that those longer-run dots acting as a kind of ceiling for US rates** (see Chart 28). In our view, this assumption might now be questioned, so **that ceiling should be softer (or even disappear) now**.

Chart 28: Median of longer-run dots has historically acted as a cap for US yields; maybe not the case now



Source: Bloomberg, Santander.

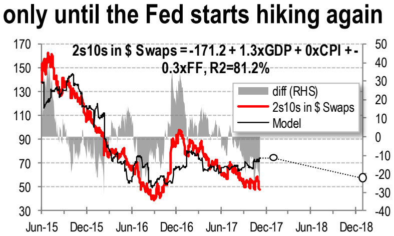
If fiscal easing materialises by year-end, 2017 highs should be tested (and probably breached in 1Q18)

Considering all these factors together, we remain comfortable with our bearish view on USTs. Indeed, we actually think we are now a step closer to seeing a clearer upward trend in US rates all along the curve. We believe that further news about fiscal easing, suggesting that the plan can be passed and start next year, along with a healthy macro scenario (and more sanguine prospects on the back of that easing), should help the market resume the upward trend in UST yields all along the curve.

Furthermore, if the Fed simply follows its plans and the market starts to price in the scenario depicted in the dot chart, and/or if the UST market starts to reflect the combination of reduced demand (SOMA unwinding) and increased supply (to finance the fiscal reform), we believe US rates might test the current 2017 highs before the year end (and probably break through them as soon as 1Q18), all along the curve.

Some additional re-steepening looks possible if macro expectations keep improving. But only temporarily, until the Fed starts hiking again

Chart 29: Current fundamentals support slightly steeper 2s10s... but only until the Fed starts hiking again



Source: Bloomberg, Santander.

The specific timing of these events is important as it could affect the shape of the US curve. As we have discussed in previous editions of this report, if macro expectations improve before the market starts to price in a more hawkish Fed for 2018 (which could well be the case), that should still leave room for some re-steepening in 2s10s (towards the 70bp area, as we recommended in our last I&E). But, as soon as the Fed starts hiking again, our models indicate that the fair value of the 2s10s slope could gradually decline back to current levels, suggesting that this move might only be temporary (see Chart 29).

Updating our forecasts

We try to reflect all these views in our forecasts for US rates over the next few quarters. As shown in Table 5 and Table 6, we expect the upward trend in front-end rates (<2y) to continue as the Fed resumes the rate hikes in December. Further out the curve, we expect the upward pressure to return and take all tenors closer to their 2017 high by year-end, although the recent ranges will probably not be breached until 2018.

The longer-run dots are no longer a strong ceiling for US rates in the belly or the long end, meaning that the whole US curve could gradually approach (and break through) the psychological 3% threshold during 2018

Table 5: Our forecasts for UST yields (%)

USTs	Current	4Q17	1Q18	2Q18	3Q18	4Q18
FOMC (mid)	1.125	1.375	1.375	1.625	1.875	2.125
3m	1.18	1.20	1.35	1.60	1.90	2.15
2y	1.61	1.80	2.10	2.40	2.70	3.00
5y	1.98	2.20	2.50	2.75	3.00	3.20
10y	2.32	2.55	2.90	3.10	3.30	3.50
30y	2.80	2.95	3.15	3.30	3.45	3.60

Source: Bloomberg, Santander.

Table 6: Our forecasts for USD swap rates (%)

$ swaps	Current	4Q17	1Q18	2Q18	3Q18	4Q18
FOMC (mid)	1.125	1.375	1.375	1.625	1.875	2.125
3m	1.40	1.40	1.55	1.80	2.10	2.35
2y	1.83	2.00	2.30	2.60	2.90	3.20
5y	2.06	2.30	2.60	2.85	3.10	3.30
10y	2.30	2.55	2.90	3.10	3.30	3.50
30y	2.53	2.70	2.90	3.05	3.20	3.35

Source: Bloomberg, Santander.

Quick update of our open trade ideas

We maintain our call on strategical front-end (Z8Z9) steepeners, strategical shorts in the forwards space (2y2y) and tactical 2s10s steepeners, trying to capture a bearish market for USTs that might initially weigh more on the belly and long end due to improving macro expectations and changes in supply/demand.

- **Trade idea: FFZ8Z9 steepeners**
  Entry level = 12.5bp. Target level = 35bp. Stop loss = 5bp

We opened this trade on 1 September, when the spread was at 12.5bp. It currently stands at 17bp, after having traded at 22.5bp as recently as 27 October. We expect the Fed to hike in December and maintain its message of more hikes being delivered throughout 2018, which should be captured by this differential. Our first target was set at 35bp, but we could revise it higher.

- **Trade idea: Tactical steepeners in 2s10s**
  Entry level = 52bp. Target level = 70bp. Stop loss = 45bp

We opened this trade on 29 September, with the spread at 52bp. It is now at 47bp, just a few bp above our stop loss, although it was trading at c.60bp on 26 October. We believe the risk remains biased towards a correction, heading to the 70bp level suggested by our fundamental models.

- **Trade idea: Pay 2y2y**
  Entry level = 2.10%. Target level = 2.40%. Stop loss = 2%

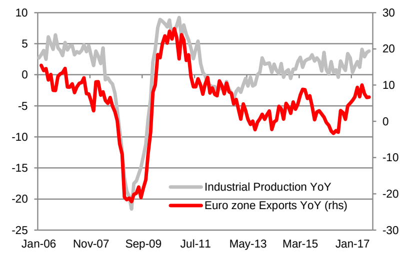
We opened this trade on 29 September, when the spread was at 2.10%, and it has remained in the money since then. It currently stands at 2.18%, with the current mark-to-market offsetting the negative carry. Like with our FFZ8Z9 steepener, we expect this trade to continue to perform as soon as the Fed resumes its rate hikes. We definitely the current levels an attractive entry point; recall that it traded 15bp higher as recently as 26 October.

Euro zone Economic Outlook

Beatriz Tejero
(+34) 91 257 2176

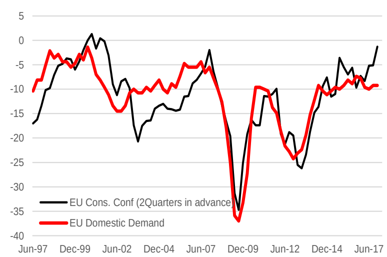
Domestic demand is increasingly important as a growth engine for the Euro zone. The structural reforms in the labour market, together with the accommodative financial conditions and contention of energy prices, should support the positive growth trend in the coming quarters.

Chart 30: Eurozone industrial production and exports



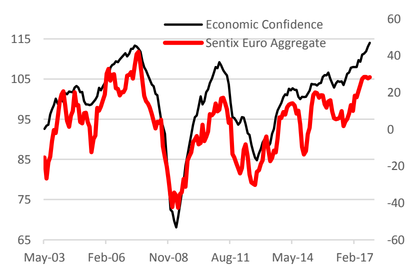
Source: Eurostat, EC and Santander.

Chart 31: Eurozone confidence and domestic demand



Source: Eurostat, EC and Santander.

Chart 32: Investors' vs. economic confidence



Source: Sentix, European Commission and Santander.

The evolution of the European currency in recent months has led to concerns about the sustainability of European growth. However, not only do exports seem to be immune to the currency's appreciation, but the softening of external demand growth is having a very limited impact on Eurozone growth. In fact, domestic demand is increasingly important as a growth engine, fuelled by the accommodative financial conditions, the structural reforms in the labour market that started being implemented back in 2012 and the moderation in energy prices. These factors seem set to support the European economy's positive growth trend in the coming quarters.

External demand now less important for Eurozone (EZ) activity

After some deceleration in June, Eurozone industrial production has gained some traction to reach 3.8% YoY growth in August vs. the 2.9% YoY rate recorded in June. Note that the slowdown in industrial production came together with a deceleration in the yearly growth rate for exports, to 7.6% YoY in June from 10.0% YoY in May. However, since mid-2017, the yearly growth rates of Eurozone exports have stalled at levels around 6.5%-7.5% YoY, while industrial activity has reaccelerated. This 'decoupling' between exports and industrial production has not been seen in the Eurozone since 2012.

Consumer confidence is solid…

The moderation in the growth rates of exports has not eroded confidence indicators. In fact, consumer confidence and economic confidence are at historically high levels and the indicators of investors' confidence have reached their highest since 2007 (before the crisis). This means that external demand's impact on activity is probably being substituted by the impact of internal demand.

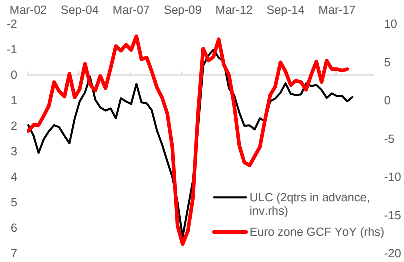
…and supported by financial conditions

On the one hand, the main factors that have fuelled consumer confidence relate to financial conditions. In fact, until mid-2014 the M1 was very closely linked to the evolution of consumer confidence and the trends in the Eurostoxx50 and consumer confidence were synchronised until mid-2015. Currently, Sentix and consumer confidence still follow the same trend. This is relevant since this indicator currently points to a significant acceleration in domestic demand in the EU until the end of 2017 vs. the 2.2% YoY recorded in 2Q17. Moreover, the number of unemployed people is dropping at the fastest yearly pace since the data started being collected back in 2001. And this has pushed the unemployment rate to its lowest since mid-2009, which should also help in terms of consumption and hence domestic demand, even if wages and salaries remain subdued in the Eurozone.

Business confidence strengthening to fresh highs

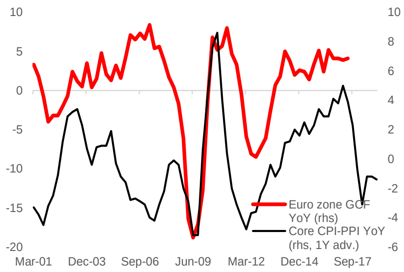
The softer export trend has not affected the Eurozone's business confidence, which posted its highest reading in October since 1Q11. This reflects the strength of domestic demand, as well as the very positive impact of financial conditions. Note that the moderation of unit labour costs is also supporting investments. In this sense, the implementation of structural reforms in countries like Spain, France, Portugal and Italy should help prolong the current growth cycle.

Chart 33: Eurozone ULC vs. investments



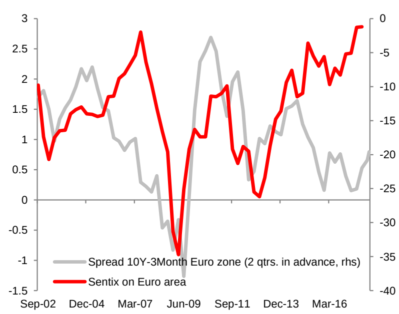
Source: Eurostat and Santander.

Chart 34: Eurozone core CPI-PPI vs. investments



Source: Eurostat and Santander.

Chart 36: Eurozone Sentix vs. 10Y-3m rates



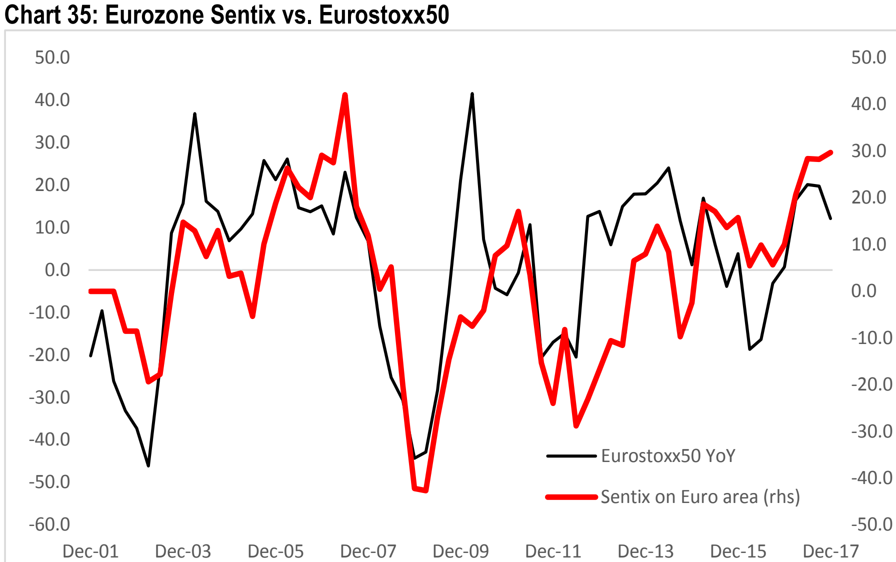
Source: IMF and Santander.

Another factor that has supported the increase in investments is low production prices that have offset retreating inflation. In fact, the differential between core inflation and the manufacturing PPI started to drop in 1Q17 and is already anticipating some softening in the yearly pace of growth of gross capital formation. We believe that this negative impact will be short-lived, since the strength of private consumption will lead to a higher core CPI and, on the other hand, the contention in wages and salaries derived from the structural reforms, together with the limited upside in energy prices, should limit the drop in the CPI-PPI differential and, hence, the erosion of investment growth.

Investor sentiment remains highly dependent on stocks, but also on rate differentials

The investors' confidence component of the Eurozone Sentix indicator is currently at its highest since 2007, and its strong relationship with domestic demand bodes well for growth in the coming quarters. Note that the Sentix is highly correlated to the equity markets but the differential between 10Y and three-month rates anticipates the Sentix remaining strong in the coming months, and this is a positive signal for consumer and business confidence and, hence, for growth.

Chart 35: Eurozone Sentix vs. Eurostoxx50



Source: Sentix, Bloomberg and Santander

In conclusion:

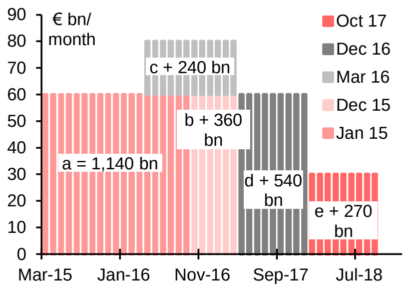
- **Domestic demand has taken, at least partially, the place of exports as the growth engine for European growth.**
- **This domestic demand is highly dependent on financial conditions** that, judging from ECB comments, are going to remain accommodative for an extended period of time. In this sense, the ongoing positive slope in the 10Y-3m rates differential has been crucial.
- The structural reforms of the labour market and the contention of energy prices are key.

Euro Rates Strategy: Low G7 inflation and a dovish ECB reaffirm the low-vol environment with a super-slow increase in rates

Luca Jellinek
(+44) 20 7756 4111

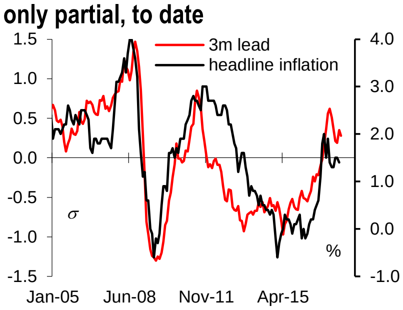
- **Throughout G10, growth is strong and inflation low. The ECB, which in the past eased slower and later, is now set to keep policy looser for longer, while the Fed normalises.**
- **The environment for EUR rates is, more than ever, one of low volatility which rewards 'short' trades with negligible or positive carry costs.**
- **Periphery news flow has recently been quite supportive and supply should decelerate into year-end. We expect further gains.**

Chart 37: A further addition to the APP



Source: ECB, Santander

Chart 38: HICP recovery has been only partial, to date



Source: Eurostat, Bloomberg, EC, Santander

A dovish ECB leaves other central banks to do the heavy lifting in rates markets

The ECB sent a clearly dovish message at the October policy meeting. The Asset Purchase Programme (APP) will be extended for nine months with **an increase of €270bn**, bringing the total to over €2.5trn, and remains nominally open-ended. This was arguably at the higher end of market expectations.

In addition, the enumeration of the extend time periods, *once* APP ends, before rates would be expected to rise or the ECB's balance sheet reduced **place strong emphasis on the forward guidance element**. To this was added the intention to leave the refi operations at full allocation and fixed rate until end-2019. Between now and year-end, the ECB stance seems likely to be viewed as an altogether bullish factor.

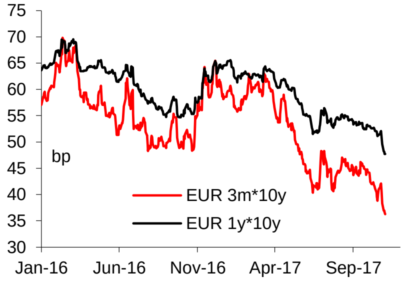
One way to look at it is that, until the ECB changes its tune, **strong output data will continue to fail to translate into significantly higher real yields**, with **the 'burden of proof', on the part of rates investors, remaining on inflation figures**.

Euro area economic confidence and PMI figures are very strong, with an improving credit environment (despite a dip in housing purchase loan demand). Employment growth also continues to be strongly positive. On the other hand, headline and core inflation continue to disappoint, with the latest flash estimate showing deceleration in both (to 1.4% and 0.9%, respectively). Such low levels are probably temporary, given that consumer price expectations have been rising, and credit and money growth has held recent gains, as have import prices and oil in EUR terms. Right now, however, **the market remains understandably sceptical of higher inflation, not least because of the ECB's stance**.

The main potential bearish factor we see for EUR rates going into year-end is higher USD rates. The US economy reflects a similar divergence between a strong recovery (preliminary Q3 GDP was higher than expected, at 3.0% q/q a, vs. 2.6%) and dull inflation figures (core and trimmed-mean inflation rates have not budged for several months, at 1.7% and 2.2%).

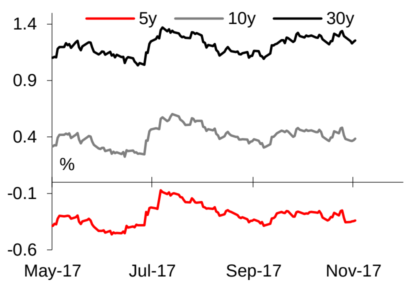
More importantly, unlike the ECB, **the Fed is committed to gradual but ongoing policy tightening**. If the current developments on the tax-reform front bear fruit, some of the long-delayed fiscal loosening would also become more tangible, despite the Trump administration's ongoing difficulty in translating policy goals into legislature. Based on Fed speakers and the 1 November FOMC meeting, the market assumption that **the Fed will hike in mid-December** seems entirely justified. More important for direction, however, is the substantial gap in end-2018 and 'long-term' policy rate expectations as expressed by money-market rates and the Fed's own 'dot plot'.

Chart 39: Euribor ATMF implied vols crashing lower



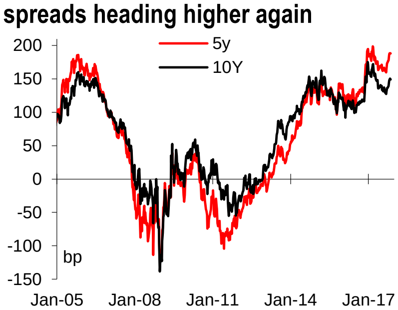
Source: Bloomberg, Santander

Chart 40: Shorted-dated EUR rates corrected lower



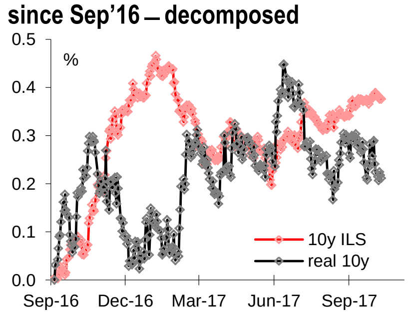
Source: Bloomberg, Santander

Chart 41: USD-EUR swap rate spreads heading higher again



Source: Bloomberg, Santander

Chart 42: Change in EUR 10y rate since Sep'16 – decomposed



Source: Bloomberg, Santander

Duration positioning in a decidedly low-vol environment

Although rates are above their early-September lows, they have yet to challenge the early-July, post-Sintra relative highs, in EUR. Indeed trading was relatively bullish for much of October, leaving the 10y roughly 15 bp below the aforesaid highs. In the year to date, the 10y has risen by an average of 1½ bp per month.

By modulating rhetoric and even policy timing to market response, central banks have been successful in keeping market-implied volatility near all-time lows, despite entering a policy normalisation process (four Fed hikes and counting, and the BoE hiking for the first time since 2007). **The ECB**, with its renewed stress on forward guidance, **has crushed implied vols**. This is also visible in the behaviour of the term structure. The 5y rate did experience a proper sell-off (after the Sintra speech by Draghi) in the summer but it has since fully corrected lower, while 10y, partly, and 30y, definitely, have held on to some of their increases.

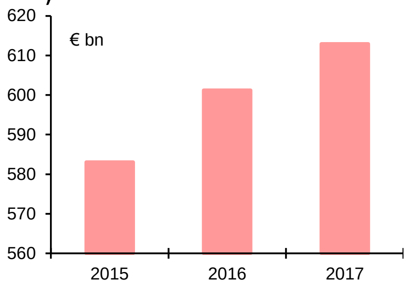
In simple terms, the lack of inflation upside and the firm stance of the ECB (and other central banks) that rates must not rise sharply consigns the **EUR fixed income market** to an **environment of extra-low volatility in the foreseeable future**. As we have illustrated in past research, this has implications for investors and liability managers. In our view, the ideal position is one that gains when G7 rates, as whole, rise but that also incurs minimal holding costs, unlike being outright short duration. Such positions include:

- **USD-EUR rates spread widening**. Both in shorter-maturity 5y and longer 10y, USD rates have rebounded significantly, since early September, vs. EUR ones. They are now not far from the cycle highs set earlier this year. It is not surprising that US rates have underperformed, given the divergence in policy rates. Data differences are more mixed but certainly do not push strongly in a tightening direction. Despite the 150 bp pick-up offered by 10y USD Libor to 10y Euribor, the difference in short-term financing rates is even larger and will grow, near term. Thus, the trade is carry-neutral to slightly positive. The USD-EUR 10y spread has been, over the past year of trading, 80% correlated to the direction in the US, though it has a significantly lower correlation to the EUR direction. We expect a return to the recent high of 175 bp

- **EUR curve steepeners**. The more the ECB convinces investors that it will stick to dovish practices (at least until Draghi's term ends in late 2019), the more any bond-bearish impulse will exacerbate curve steepness. The slopes between most tenors at the short end and medium- to long-term tenors have shown correlations in the 75% to 95% range relative to direction. We have an outstanding 5s10s steepener recommendation that is in the money and which we think has further to go. The carry cost of such a steepener is a measly 1bp / year.

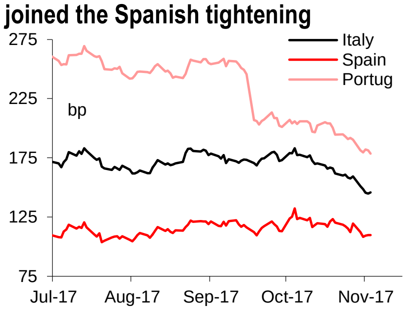
- **Receiving inflation**. Although one reason for central bank caution is the lack of inflation 'delivery', it is interesting that market-implied longer-term inflation (like 10y IL swap) has held in pretty well and 'real' rates have corrected lower. Note, too, that relative to recent oil price dynamics, nominal rates (and, to a lesser degree, ILS) look low. We have had a 2030 SPGB€I break-even receiving position on since early this year and the main contribution to its performance has been the inflation accrual, rather than a sharp rise in the break-even itself. Put simply, the break-even rate on these bonds is lower than the pace at which inflation is currently accruing and likely slower than future inflation. Such a trade can easily be executed using inflation-linked swaps (ILS) though the carry is not as positive.

Chart 43: Aggregate, general government revenues (ITL + ESP + PTE)



Source: MEF, MEyH, DGO, Santander

Chart 44: Italy and Portugal have joined the Spanish tightening



Source: Bloomberg, Santander

Another chapter in the periphery outperformance story

A macroeconomic and policy context characterised by growing output and employment in Europe while the ECB remains very accommodative is clearly supportive for periphery sovereign risk. The effects of stronger growth are visible in government tax revenue figures. In Italy, Spain and Portugal, in the year to August, they are roughly 2-3% higher relative to the same period in 2016, and over 5% above the 2015 level. Taking Italy, Spain and Portugal in the aggregate, unemployment has fallen by 520k people in the first half of the year, while gross employment grew by 567k people. Where more recent data are available, Q3 seems to have been at least as positive.

All this points to tighter periphery EGB spreads. That is not just because of individual supportive fundamental developments but also the fact that **the balance of news has improved across the board**. Spain and Portugal have been doing well for some time but, over the course of 2017, Italy has also shown more economic and institutional upside, and even eternal laggard Greece has put in some stronger numbers and a better relationship with the EC. As a result of this synchronised good news flow, a capitalisation-weighted average 10y spread of BTPs, SPGBs and PGBs against Bunds has put in the **best monthly performance since March 2016**.

Given the usual Q4 supply deceleration likely to kick in in November and December, and the macro/policy environment set to remain supportive, **we expect the momentum for periphery spreads to remain positive into year-end**, despite the potential for some window-dressing by domestic bank treasurers in some jurisdictions.

Positive Italian news flow can further boost BTPs

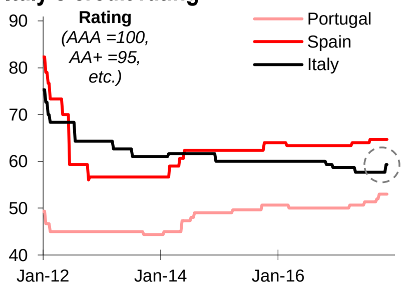
Economic developments in Italy have been encouraging. Nominal and real GDP growth, so far in 2017, is still lower than elsewhere in the periphery but industrial production and, especially, **economic confidence readings have accelerated sharply since mid-year**, which suggests some potential for catching up in coming quarters. Judging by the performance of export growth, relative unit labour costs and the basic balance, the competitiveness of Italy's economy is satisfactory, despite flat labour productivity growth. Employment growth, which is crucial from political and fiscal standpoints, has been clearly positive.

The banking system remains affected by a high level of nonperforming loans, but **bank credit spreads and equity pricing have improved significantly** following the loss-minimising deal between the EC and Italian authorities earlier this year and the subsequent flow of capital and asset disposals.

Lastly, from the political standpoint, **concerns about the risk of some sort of rupture between Italy and EC orthodoxy have been reduced significantly**. 'Anti-system' parties have significantly moderated their stance on the Eurozone and a new electoral law that respects brings homogeneity to the process, after a spate of constitutional court decisions against preceding election rules, has increased transparency. Opinion polls continue to show a roughly even split between the centre-left, centre-right and 5-Star Movement, with the centre-right recently making gains.

With the recently approved electoral system, this split would still equate to **some sort of minority / grand-coalition government, with elections possible as early as Q1-18**. What seems to matter to investors is generally the forestalling of any dramatic change in direction. This sense that business-as-usual is not necessarily prejudicial to improving fiscal sustainability has been reinforced by the aforementioned economic recovery and a better-than expected set of institutional / economic reforms under a 'caretaker' government, headed by PM Gentiloni, that was given little chance of success at its onset, late last year.

Chart 45: A surprise upgrade in Italy's credit rating



Source: Rating agencies, Santander

To crown the supportive news flow for BTPs, **late in October S&P surprised the market by upgrading Italy's rating from BBB- to BBB**. This, of course, runs counter to the two downgrades that Italy received earlier in the year (by Fitch and DBRS).

The subsequent BTP outperformance vs. Spain has been dramatic. At current pricing, we would expect a more gradual trend.

Spain's fundamentals are quite solid…

Macro data in Spain look quite solid. The basic balance, at roughly +3% of GDP despite a rebound in domestic consumption, is flattering and fixed investment is accelerating. **In less than two years, the unemployment rate has been reduced by four percentage points**. Nominal GDP growth has remained in the 3-4% range, well above the average funding rate. Spain's fiscal deficit expectations have been tweaked lower by the IMF and the government, reflecting above-average growth, and are on track for the best year since 2007.

Official sources inside and outside Spain expect the dislocation created by the acrimonious dispute between the Catalan and central governments to be reflected in late-2017 data, but the assumption is that it will be a transitory effect. The combination of solid growth, improved fiscal balance and moderate interest rates has allowed Spain to reduce its comparatively moderate **debt/GDP ratio. By year-end it should be under 100% in gross terms, which is just above the level for France and several points below that of the US**.

There are no further scheduled ratings reviews for Spain in the remainder of 2017. Having had two outlooks (S&P and Fitch) shifted from 'stable' to 'positive', it seem likely that upgrades will follow in H1-18.

…and investors seem less concerned about politics

Through October, news flow regarding Spain has been dominated by the confrontation between the separatist Catalan autonomous community government and the unionist Madrid central government, following a controversial referendum on 1 October. At the time of writing, the situation seemed calm and the Spanish government had implemented the direct take-over of regional government directive functions, as approved by the Senate. Fresh elections in Catalonia are scheduled for 21 December, with polls suggesting opinion remains quite divided.

The market perception is that the political and institutional momentum for a significant constitutional break has fizzled out, for the foreseeable future, though the issue will continue to be of interest among investors.

On a separate political note, the overall position of Spain's mainstream parties, again based on opinion polls, appears to have been strengthened and there is no discernible prospect of early elections at the national level.

PGBs can keep performing in the current climate

The star performer over the past quarter, among periphery sovereigns, has been Portugal, which we have long advocated as an underappreciated periphery success story.

In financing terms, Portugal has continued to reduce its exposure to comparatively expensive IMF loans, with 66% re-paid or pre-paid as at October. It has also pre-financed roughly 40% of 2018's likely borrowing needs. Over the past 12 months, the unemployment rate has dropped by two full percentage points and, at 8.6%, is now below the EMU average.

The expected 2017 deficit is a rather slim 1.4% of GDP and should shrink further to 1% in 2018. Its nominal GDP growth rate, in the 3-4% range, is far higher than its average borrowing cost, helping to **stabilise and reduce debt / GDP levels. In 2017**, that reduction is expected to be **in excess of 4% of GDP**, though it remains high, at above 125%. Having received a rating upgrade from S&P in September, we would not be surprised if its rating is also upgraded by Fitch, which has their outlook on ‘positive’, in mid-December.

In terms of political stability, the recent municipal elections confirmed the popularity of the sitting Socialist Party-led government, which polls well ahead of its competitors. The second-highest-polling party, the Social Democrats, is also one of the two mainstream, traditional ruling parties, making **Portugal an example of a polity that, despite some very difficult years, has not deviated substantively from its centrist, EU-friendly roots**.

Given all the supportive fundamental and supply/demand factors, **we believe that there is room for substantial tightening of PGB-Bund spreads, currently 180 bp in CMT terms, and target around 155 bp by year-end**.

Euro government bond supply: YTD update

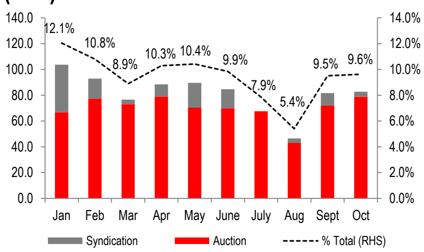
Edgar da Silva
(+34) 91 257 22 44

Euro area govie issuance at 96% completion with two months to go till the end the year

After the few first days of November, EUR issuers have sold more than €829bn of bonds via both ordinary auctions (close to €713bn) and syndicated deals (€116.3bn), representing an average of 96.4% of their combined 2017 issuance target (c.€860bn).

In terms of YTD completion rates by country, all the Eurozone issuers, bar Finland, have surpassed the 85% mark. Ireland (116%), France (109%), Austria (106%) and Belgium (105%) have already issued more than initially planned for 2017, with still a little less than two months to go to the end of the year. The next in line to reach the 100% mark are Spain, the Netherlands and Italy, which have already covered 95%, 94% and 92% of their 2017 targets, respectively. Then, we have Germany (89%) and Portugal (87%), while Finland is only at the 80% mark, making gradual progress towards completion (see Table 7).

Chart 46: Monthly EZ supply – YtD (€bn)



Source: Bloomberg

Table 7: Total issued in EZ in 2017, by country (updated as at 6 November)

	GE	FR	NE	AS	SP	BE	PO	IT	IR	FI	TOTAL EZ (€bn)
YtD auctioned issuance	132.0	186.9	29.7	12.0	98.7	20.6	10.1	212.5	6.9	3.5	712.8
YtD syndicated issuance	0.0	14.0	0.0	14.5	27.0	16.3	3.0	24.1	8.2	9.3	116.3
YtD Issuance	132.0	200.9	29.7	26.5	125.7	36.8	13.1	236.6	15.1	12.8	829.2
2017 programme	149.0	185.0	31.6	25.0	133.0	35.0	15.0	257.1	13.0	16.0	859.7
% completion (RHS)	89%	109%	94%	106%	95%	105%	87%	92%	116%	80%	96.4%

Source: Bloomberg , Santander

Table 8: YTD issuance completion vs. historical data

	2012	2013	2014	2015	2016	2017	Aver 12-16
GE	93%	91%	92%	94%	93%	**89%**	93%
FR	95%	94%	93%	94%	94%	**109%**	94%
NE	96%	96%	97%	95%	96%	**94%**	96%
AS	91%	89%	94%	90%	95%	**106%**	92%
SP	85%	92%	92%	93.2%	92%	**95%**	91%
BE	95%	100%	97%	96%	96%	**105%**	97%
PO	-	100%	96%	97%	98%	**87%**	98%
IT	90%	90%	93%	94%	93%	**92%**	92%
IR	100%	100%	84%	100%	95%	**116%**	96%
FI	100%	100%	99%	98%	96%	**80%**	99%
TOTAL EZ (€)	**92%**	**92%**	**93%**	**94%**	**94%**	**96%**	**93%**

Source: Bloomberg. YtD (calendar year) data for 2017. Jan-Nov aggregates for historical data.

EUR supply: 2018 preview

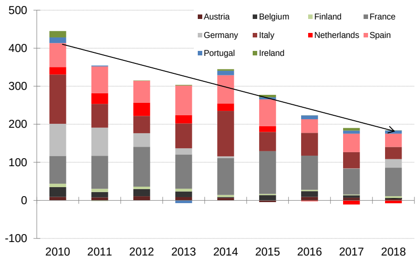
As we approach year-end, and with many EUR issuers close to completing their 2017 issuance programmes (and some actually having overshot them), we are beginning to forecast their 2018 supply. Over the next few weeks, the debt agencies will be updating their funding plans and we will post the latest information as it becomes available.

So far, France and the Netherlands have published approximate funding estimates for next year. Other Euro area governments have presented their 2017 budgets to the European Commission and their respective Parliaments, with these still to be approved and then incorporated into their respective Treasury agency plans.

On 27 September, the AFT announced its funding requirements for 2018, after the French government adopted its 2018 Budget. Next year's financing needs are estimated at €203.3bn for France, with medium- and long-dated (namely OATs) issuance amounting to €195bn, €10bn more than targeted for the current year (€185bn). According to the AFT, of the total, €82.9bn will be used to finance the deficit, €120.1bn for the redemption of its medium- and long-term debt maturing in 2018, and €0.3bn "for other cash requirements". Note that the details of next year's French funding programme will be published in December.

According to the DSTA's Quarterly Outlook, the Netherlands is expected to need around €1bn more funding next year (€49.6bn) than in 2017 (€48.7bn) given its higher capital market redemptions, but helped by "the expectation that the cash surplus will again be significant next year". According to our estimates, DSL requirements for 2018 could again be around €30-32bn, as the Dutch agency uses the cash surplus to cover part of next year's redemptions (€40bn). We will have to wait until 15 December, when the DSTA publishes its outlook for 2018, for more details on the borrowing requirements for next year, as well as the 2018 funding plan.

Chart 47: Net supply in the Euro zone (ex GR)



Source: Bloomberg, Santander

Draft budgetary plans sent to the EC in October should help us estimate other EUR issuers' supply

Considering the Eurozone member States' 2018 draft budget plans (sent to the European Commission this October for approval), plus their 2018 redemptions, we have prepared our own estimates of gross issuance for next year. Our analysis for those countries that have not released their 2018 programmes yet is based on the central governments' fiscal balance targets for 2018. We then calculate the gross borrowing requirements for 2018 by adding this expected deficit and the amount of medium- and long-term bonds maturing next year (see Table 10). The differences between the initial estimates and the final programmes should be fairly small and will be corrected as their issuance programmes are published.

Table 9: 2018 net and gross supply by country vs. 2017

(€bn)	2018 Gross Issuance	Difference (vs. 2017)	2018 Net Issuance	Difference (vs. 2017)
Austria	23.0	*-2.0*	3.5	*-3.5*
Belgium	31.9	*-3.1*	2.7	*-3.6*
Finland	12.8	*-3.2*	4.6	*2.4*
France	195.0	*10.0*	75.0	*7.5*
Germany	182.7	*33.7*	22.7	*15.7*
Italy	224.6	*-32.5*	31.8	*-10.8*
Netherlands	32.5	*0.9*	-7.5	*3.4*
Spain	114.2	*-18.8*	35.0	*-13.7*
Portugal	15.0	*0.0*	8.2	*0.0*
Ireland	9.4	*-3.6*	0.6	*-6.2*
TOTAL EZ (Ex GR)	841.2	*-18.5*	176.7	*-8.7*

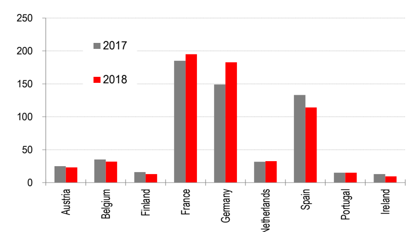
Source: European Commission, EZ countries' Debt Agencies, Bloomberg, Santander

Both gross and net supply to decline in 2018

Over the last few years, Euro area countries have made efforts to comply with the 3% budget deficit target established in the Euro 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 2018 should be no different. In fact, we think we could have reached a stabilization point as **net supply will decrease by only a small fraction in 2018** (Chart 47).

We estimate a 5% decline in net issuance (Table 9), from €186bn in 2017 to c.€177bn in 2018 (excluding Greece). The countries expected to reduce their planned net borrowings the most next year, relative to 2017, are Ireland (-91%), Belgium (-57%), Austria (-50%), the Netherlands (-31%), Spain (-28%) and Italy (-25%). On the other hand, we should see increases for Germany (+224%), Finland (+111%) and France (+11%). Our estimates show Portugal's requirements staying flat.

Chart 48: Gross issuance by country, 2017 vs. 2018



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

With bond redemptions decreasing for the first time in the last five years (from €665bn last year to €674bn in 2018), we expect next year's gross supply to be c.€19bn (or -2%) lower than last year's, at €841bn (excluding Greece, which is expected to be timidly active in the market next year).

By country, Germany (+23%), France (+5%) and the Netherlands (+3%) should boost their planned gross issuance versus 2017 next year. On the other hand, Ireland (-28%), Finland (-20%) Spain (-14%), Italy (-13%), Belgium (-9%) and Austria (-8%) are expected to scale back their gross issuance in 2018. Lastly, Portugal should maintain a similar level of gross issuance as last year.

Table 10: Eurozone central governments' estimated gross borrowing requirements and redemptions in 2018

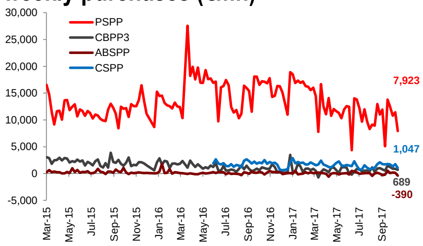
	2018 Redemptions & Coupon Payments																									2018 Bond
	Jan		Feb		Mar		Apr		May		Jun		Jul		Aug		Sep		Oct		Nov		Dec		TOTAL	Supply
(€bn)	R	C	R	C	R	C	R	C	R	C	R	C	R	C	R	C	R	C	R	C	R	C	R	C	Redempt	Target
Austria	12.2	0.7	-	0.1	0.2	1.4	-	0.4	-	0.2	-	0.4	-	1.1	-	-	-	0.6	7.1	0.7	-	0.4	-	-	19.5	23.0
Belgium	-	-	-	-	12.7	5.1	0.3	-	2.5	-	12.7	2.4	-	0.3	-	-	0.2	2.6	-	-	0.1	-	0.7	-	29.2	31.9
Finland	-	-	0.2	-	0.1	-	-	0.7	1.3	-	-	-	-	0.7	-	-	5.0	0.2	1.3	-	-	-	0.3	-	8.2	12.8
France	-	-	13.7	-	-	-	28.2	14.3	18.7	5.1	-	0.2	9.4	2.8	-	-	-	-	28.2	13.7	21.8	1.3	-	-	120.0	195.0
Germany	20.0	7.2	17.0	1.1	13.0	-	32.0	0.6	-	0.5	14.0	-	21.0	8.0	-	1.4	13.0	1.0	17.0	0.3	-	-	13.0	-	160.0	182.7
Ireland	-	-	-	0.1	-	1.2	-	0.5	-	0.4	-	0.5	-	-	-	-	-	-	8.8	1.2	-	-	-	0.2	8.8	9.4
Italy	16.2	0.1	21.9	5.8	12.3	11.1	13.6	0.7	13.9	5.7	19.4	2.5	-	0.4	24.7	5.4	10.9	11.1	12.6	0.6	12.7	5.6	34.6	2.1	192.8	224.6
Netherlands	13.3	3.8	-	-	-	-	12.8	-	-	-	-	-	13.9	3.3	-	-	-	-	-	-	-	-	-	-	40.0	32.5
Portugal	0.1	-	-	1.1	-	-	0.1	2.2	-	-	6.6	1.2	-	0.2	-	-	-	-	-	1.1	-	-	-	-	6.80	15.0
Spain	19.5	6.8	-	-	1.7	0.1	16.8	4.8	-	-	-	-	20.8	7.9	-	-	-	-	20.4	7.0	-	0.4	-	-	79.2	114.2
TOTAL EZ (€)	81.3	18.6	52.8	9.1	40.0	19.0	103.8	24.3	36.4	11.9	52.7	7.3	65.1	25.1	24.7	6.9	29.1	15.5	95.4	24.8	34.6	7.7	48.6	2.3	664.5	841.2

Source: European Commission, EZ countries' debt agencies, Bloomberg, Santander. As per each country's Draft Budgetary Plan for 2018 for, except for those issuers that have specifically announced their 2018 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 to assume funding needs from other public issuers (agencies, regional governments, etc.)

Update on the ECB's EAPP: €2.2trn in total

The ECB's latest report on its Extended Asset Purchase Programme (EAPP) holdings, which includes the purchases settled as at 3 November, shows that it has accumulated more than €2.2trn since the programme began in March 2015. The PSPP portfolio now amounts to €1,804.5bn, just €7.9bn more than the previous week (which saw a rise of €11.4bn reported). CBPP3 holdings reached €236.5bn, €689mn more than in the previous week (versus the €0.9bn growth posted last week). The CSPP now amounts to €122.3bn, an increase of €1bn (vs. last week's figure of €1.8bn). Lastly, ABSPP holdings declined by just €390mn to around €24.7bn, after the €148mn increase seen in last week's report.

Chart 49: The ECB's EAPP portfolio - weekly purchases (€mn)



Source: Bloomberg, ECB, Santander

By country, the latest information available (Table 12) is the breakdown of PSPP debt security holdings the ECB published on 6 November, which we commented on in detail in our MMD report of 7 November, including the expected monthly APP redemptions with a rolling 12-month horizon. In summary, the figures show that October's public sector purchases totalled €50.2bn, €45.1bn of which were EUR govies (a €610mn decrease vs. September) and the rest supranational debt, which decreased by €12mn.

The ECB also published the expected monthly redemption amounts for its APP over a rolling 12-month horizon, as announced in its last ECB meeting two weeks ago (Table 11). For the month of October, the ECB has reinvested or had plans to reinvest around €10bn from the bond redemptions in its EAPP portfolio. And, for the following 11 months, the ECB has indicated that the bond redemptions are estimates, which could be revised on a monthly basis. So, for now in November, the ECB estimates that it could be reinvesting more than €3.1bn, of which €2.2bn would be applied in the PSPP, €476mn in the ABSPP, €410mn in the CBPP3 and €95mn in the CSPP.

Table 11: Expected monthly redemption amounts for the ECB's APP over a rolling 12-month horizon

(EUR million)	ABSPP	CBPP3	CSPP	PSPP	APP
Oct 17 *	846	502	165	8,462	9,975
Nov-17	*476*	*410*	*95*	*2,159*	*3,140*
Dec-17	*624*	*1,527*	*0*	*120*	*2,271*
Jan-18	*691*	*2,865*	*165*	*4,584*	*8,305*
Feb-18	*816*	*1,326*	*294*	*6,299*	*8,735*
Mar-18	*584*	*1,241*	*240*	*3,930*	*5,995*
Apr-18	*502*	*1,133*	*87*	*22,600*	*24,322*
May-18	*372*	*1,135*	*520*	*6,190*	*8,217*
Jun-18	*581*	*3,202*	*461*	*11,553*	*15,797*
Jul-18	*718*	*1,617*	*345*	*16,064*	*18,744*
Aug-18	*499*	*475*	*137*	*854*	*1,965*
Sep-18	*550*	*1,463*	*697*	*6,005*	*8,715*
Oct-18	*598*	*1,647*	*237*	*21,126*	*23,608*
13-month Average	604	1,426	265	8,457	10,753

Source: ECB, Santander. *Actual redemption, based on month end data. ECB estimates in italics. Figures may not add up due to rounding. Figures are preliminary and may be subject to revision. Note: Realised redemptions may differ from estimated redemptions.

Also, as seen in Table 11, estimated redemption peaks are seen for the months of April, July and October next year, so we could see a sharp increase in activity around these months. However, we think the ECB will try to avoid peaks by smoothing out its reinvestments in the two-month period stated by the programme, trying to avoid an unnecessary market impact (as EUR govie issuers, typically, do not increase their bond issuance around redemption dates). That is significant because, if the ECB tries to share the "load" of these redemptions across the months, the demand side (caused by these reinvestments) should accommodate itself to the offer side (Treasury agencies try to maintain a relatively stable pace of gross issuance throughout the year, not dependent on their own redemptions), so the impact of these redemptions might not entail the seasonal component that the data presented yesterday might suggest.

Table 12: The ECB's PSPP monthly purchases - Country breakdown

Holdings (€mn)	1Q15 (Mar' 15)	2Q15	3Q15	4Q15	1Q16	2Q16	3Q16	4Q16	1Q17	2Q17	3Q17	Oct'18	Monthly Change	Monthly Avge	2015 Purchases	2016 Purchases	2017 Purchases	Total Purchases
Austria	1,215	3,828	3,706	3,890	4,060	6,049	5,116	5,334	5,816	4,548	4,213	1,451	-15	1,538	12,639	20,559	16,028	49,227
Belgium	1,527	4,843	4,637	4,888	5,126	7,648	6,449	6,716	7,257	5,739	5,321	1,831	-21	1,937	15,895	25,939	20,148	61,982
Cyprus	-	-	98	187	- 16	-	- 21	-	-	- 34	- 1	-	1	7	285	- 37	- 35	214
Germany	11,063	35,262	33,752	35,541	37,198	55,446	46,803	48,874	51,650	36,301	33,648	11,551	-125	13,659	115,618	188,321	133,150	437,095
Estonia	-	5	33	10	13	5	-	-	-	-	-	-	-	2	48	18	-	65
Spain	5,444	17,294	16,562	17,513	18,343	28,175	23,052	23,944	25,615	18,844	17,509	6,010	-101	6,822	56,813	93,514	67,978	218,310
Finland	774	2,463	2,362	2,487	2,615	3,914	3,280	3,403	2,233	1,953	1,384	1,052	850	873	8,086	13,212	6,622	27,915
France	8,752	27,535	27,037	28,438	29,810	44,014	36,947	38,329	41,505	32,871	30,374	10,488	-562	11,128	91,762	149,100	115,238	356,106
Ireland	721	2,293	2,234	2,333	2,393	3,275	2,665	2,649	1,669	1,556	1,664	- 32	-609	732	7,581	10,982	4,857	23,418
Italy	7,604	23,977	23,201	24,422	25,588	39,212	32,151	33,447	35,977	28,503	26,484	9,121	-83	9,678	79,204	130,398	100,085	309,691
Lithuania	39	339	394	335	343	322	193	299	210	147	92	60	31	87	1,107	1,157	509	2,773
Luxembourg	183	550	304	78	423	77	16	112	151	186	163	39	-16	71	1,115	628	539	2,282
Latvia	75	429	64	117	115	224	144	145	160	106	80	48	21	53	685	628	394	1,707
Malta	5	204	53	20	141	163	30	191	108	41	59	15	-6	32	282	525	223	1,030
Netherl.	2,486	7,858	7,473	7,795	8,393	12,360	10,591	10,868	11,715	8,269	7,471	2,574	-25	3,058	25,612	42,212	30,029	97,853
Portugal	1,073	3,422	3,274	3,450	3,624	4,294	2,702	2,770	2,007	1,528	1,425	489	-5	939	11,219	13,390	5,449	30,059
Slovenia	209	679	651	690	769	732	595	609	462	391	466	164	5	201	2,229	2,705	1,483	6,417
Slovakia	506	1,597	1,332	1,187	1,562	885	477	610	929	681	458	228	50	327	4,622	3,534	2,296	10,452
Sub Govies	**41,676**	**132,578**	**127,165**	**133,383**	**140,511**	**206,793**	**171,192**	**178,298**	**187,462**	**141,631**	**130,809**	**45,090**	**-609**	**51,143**	**434,802**	**696,794**	**504,992**	**1,636,596**
Supras	5,680	18,187	18,028	18,206	18,871	23,451	18,951	19,853	20,922	15,777	14,700	5,084	-12	6,178	60,101	81,126	56,483	197,711
TOTAL PSPP	**47,356**	**150,765**	**145,193**	**151,589**	**159,382**	**230,244**	**190,143**	**198,151**	**208,384**	**157,408**	**145,509**	**50,174**	**-621**	**57,322**	**494,903**	**777,920**	**561,475**	**1,834,307**

Source: Bloomberg, ECB, Santander

UK Monetary Policy Outlook

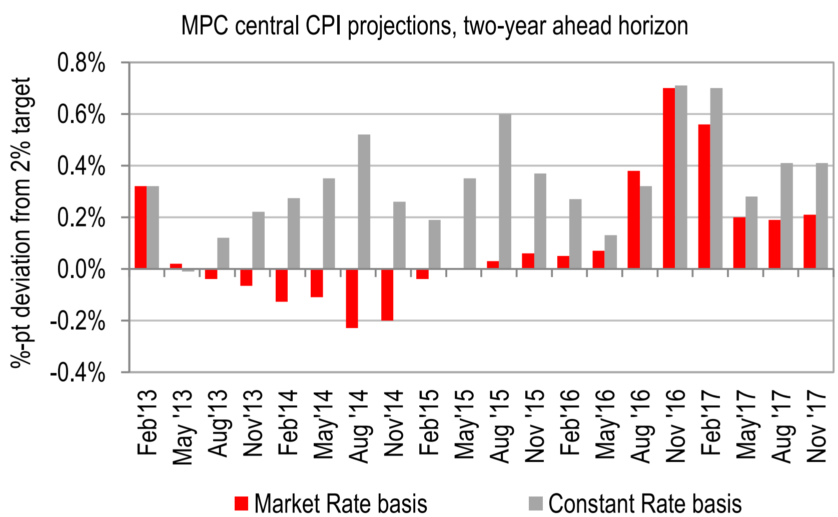
Stuart Green
(+44) 207 756 6170

- **The November MPC meeting produced the first UK hike for a decade, but market response proved a repeat of August's dovish reaction**
- **After stressing the importance of the inflation overshoot in the change in policy, MPC communications offered no guidance on future policy, even while the updated CPI forecasts were well above target**
- **With the policy pressures from the economy's supply-side unlikely to reverse, we believe the MPC may soon need to shift policy guidance once again.**

UK Monetary Policy Update: Old habits die hard

The prospect of a first interest rate increase in the UK in a decade had been billed as a watershed moment for the UK markets ahead of this month's Bank of England Monetary Policy Committee (MPC) meeting. A 25bp hike (to 0.5%) was duly delivered, while all other areas of policy were left unchanged, thereby cementing a major shift in the interest rate outlook since the summer. But, we believe that many aspects of the market's response to the rate hike bore a strong similarity to that observed just three months earlier, when a dovish reaction followed the release of the August Inflation Report, despite what we at the time regarded as a relatively hawkish set of CPI projections. However, whereas the market may have been accused of disregarding the MPC's message back in August – prompting policymakers to adopt a much blunter tone at the September MPC meeting– this month's reaction was, in our view, encouraged by a strange lack of guidance from the Committee, around future policy even while the November Inflation Report painted an overall hawkish picture of the UK economy over the next two to three years.

Chart 50: The Bank of England's inflation forecasts appear little changed by the Bank Rate hike, with a substantial overshoot still signalled



Source: Bank of England, Santander
Note: Chart shows evolution of the MPC's 2-year ahead CPI projections, presented on both a constant rates and market rate-conditioned basis. Data taken from each Inflation Report released since February 2013.

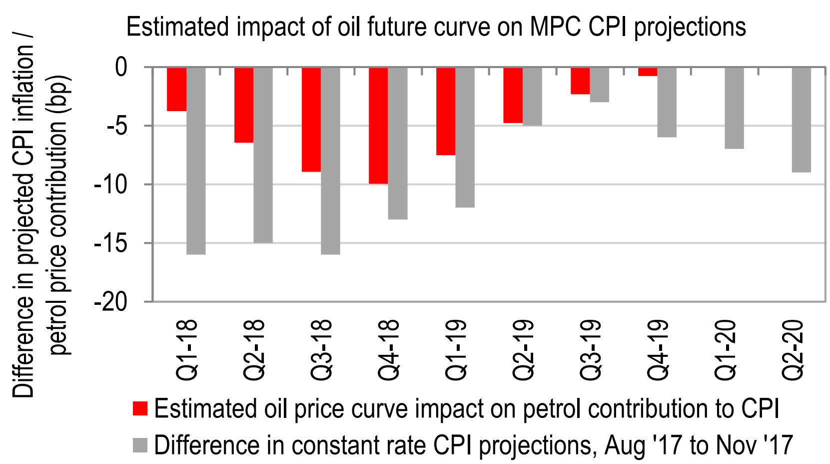
The motivation for this month's rate hike has typically been attributed to a declining tolerance across the MPC for above-target inflation, given both the resilience of demand across the UK economy since last year's EU referendum, and an assessment of how the subsequent Article 50 process may impact its longer-term supply potential. At the August Inflation Report, the Committee projected CPI inflation of 2.47% in Q4-19 on the assumption of Bank Rate remaining at 0.25%, and an inflation rate of 2.25% based on the assumption that Bank Rate rise in line with the market expectations. The policy message –given the reduced tolerance for above-target inflation– was therefore one of a faster pace of policy tightening being required than that implied by the prevailing market pricing, a threat reinforced by the September shift in rhetoric and, ultimately, the rate hike itself.

MPC's CPI projections little changed, and still hawkish

Having established a broad outline of the MPC's likely reaction function, we saw the response to this month's Super Thursday as resting upon how the shift in the interest rate outlook had worked to reduce the projected inflation overshoot. In the event, we believe that the November Inflation Report's CPI projections were, in fact, surprisingly high, with the constant rate Q4-19 forecast –now, of course, based on a 0.5% Bank Rate rather than 0.25%– falling only very marginally to 2.41%, while the market rates-conditioned figure also remained little changed, at 2.21% (see Chart 50). Given the enhanced sensitivity of the MPC's forecasts to changes within interest rates, we argue that these updated forecasts are consistent with a more serious, perceived inflation threat than was the case in August.

Indeed, we estimate that the shift in the profile of the oil futures curve –from upward sloping in August to a declining trajectory in November– may have directly reduced the MPC's CPI projections by roughly 10bp during the Q3-18 to Q2-19 period (see Chart 51). Again, this would suggest that the MPC's underlying concerns around the inflationary outlook are likely to have increased over the past few months. But, whereas the Committee was keen to impress this message upon investors just a few weeks ago –and how this could require a faster pace of tightening than market pricing implied– the minutes to this month's meeting were effectively bereft of any meaningful policy guidance, save for the customary reference to "limited and gradual" rate hikes. In the event, the failure to warn of a faster pace of tightening (relative to prevailing pricing) sparked a significant rally across UK rate markets which, according to the MPC's forecasting process, will serve to push the headline CPI projections even further above target.

Chart 51: The shift in the oil futures curve since the summer may account for a significant share of the fall in CPI forecasts relative to the August Inflation Report



Source: Bank of England, Bloomberg, ONS, Santander.
Note: Chart shows the difference between the August and November 2017 Inflation Report CPI projections, based on the assumption of constant rates, and the estimated impact of the shift in the oil futures curve on these CPI projections.

What could explain this apparent change of approach from the Committee given that, as stated above, the inflationary concerns that drove the change in policy direction over the past quarter appear to have intensified? Indeed, one of the more notable features of this month's press conference was Governor Mark Carney's admission that the economy is now seen as likely to be operating above its productive potential by the end of the forecast horizon, implying a further (and continued) acceleration of domestically-generated inflation.

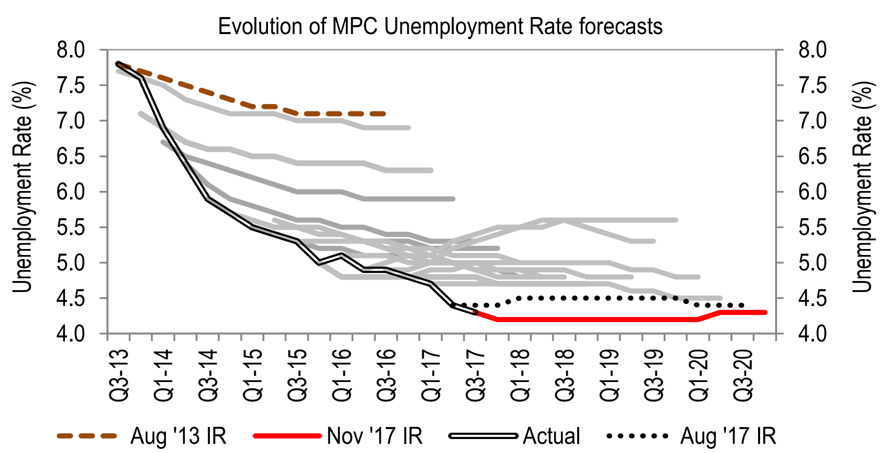
Competing explanations, but little insight into guidance switch

The simplest explanation relates to the MPC wishing to retain full flexibility around policy within a highly uncertain environment, after an initial rate hike which, on face value, could be seen to reaffirm the commitment to price stability. But we see a key distinction between sensibly avoiding any pre-commitments on policy, and failing to offer a consistent level of policy guidance that stresses the data dependency of the MPC's likely actions. Indeed, if visibility around the UK economy really is so poor that it prevents any consistent degree of policy guidance being offered by the MPC, then a rate hike (as we previously argued) should perhaps have been avoided altogether.

A further potential explanation relates to the balance of opinion across the Committee itself. Deputy Governors Ramsden and Cunliffe both voted against a rate hike this month, in the 7-2 vote, and if the initial 25bp move was only supported by a fragile majority, then the ability to signal further rate hikes would naturally reduce. But the distribution around the MPC's updated CPI projection fails to suggest any major increase in uncertainty around the central forecast. Moreover, had the minutes signalled a variety of views surrounding the central outlook for policy, this would at least have provided valuable information for investors now having to reappraise the outlook for UK monetary policy.

Given our view that this month's rate increase will prove a one-off move from the MPC due to our more dovish appraisal of the inflation outlook – indeed, we see Bank Rate remaining at 0.5% through to end-2018– the lack of firm guidance with regard to future hikes should perhaps be welcomed (from a very selfish perspective). But we remain concerned that this latest shift in communication from the MPC –and the very dovish market reaction– could simply be storing up problems for UK markets further down the line.

Chart 52: Falling unemployment has proved a persistent theme, but one not well anticipated by the Bank of England's forecasts



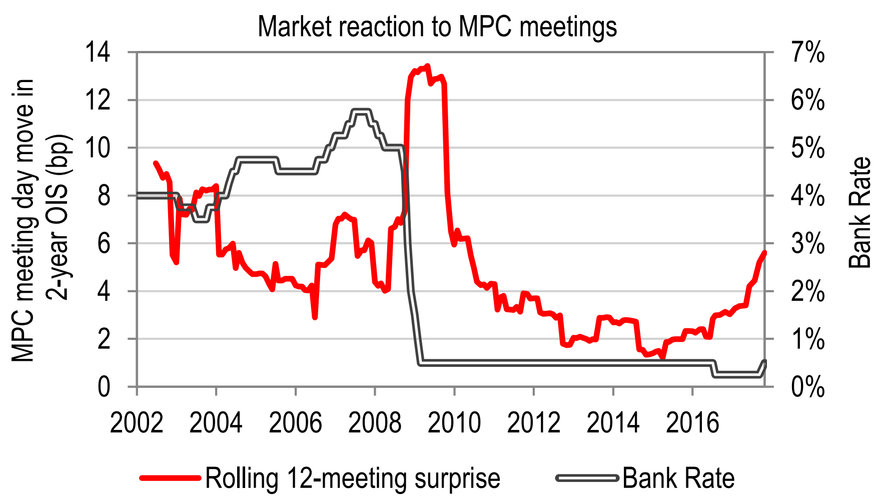
Source: Bank of England, Santander.
Note: Chart shows the evolution of the Bank of England's market interest rate-conditioned unemployment forecasts. Data taken from each Inflation Report released since August 2013.

Visibility reduced and uncertainty on the rise

The outlook for productivity growth and the UK economy's supply potential is unlikely to be transformed over the next six to nine months, not least because of the uncertainty around the Brexit process. The assessed degree of labour slack may also continue to decline –continuing the trend of the MPC's unemployment forecasts (see Chart 52)– and the November Inflation Report places the UK's CPI still comfortably above target by the end of the forecast horizon (at 2.15% in Q4-20). In this environment, the forces influencing the monetary policy decision are likely to endure, even if the MPC's guidance around the outlook continues to change, switching from the very hawkish rhetoric seen in September to the uncertainty that followed the November meeting.

Rather than providing a clearly dovish move, therefore, the MPC's failure to maintain the policy guidance operated during the summer months could, in our view, simply be increasing the uncertainty surrounding the UK monetary policy outlook, and lead to more volatility across UK markets in the coming months. Indeed, after waiting an entire decade to raise Bank Rate, and managing to provide a dovish surprise when it did, we believe that the MPC could soon be signalling that a faster pace of monetary tightening is likely to be required. Already, we note that the market volatility observed around MPC announcements is now approaching the highest levels for a decade, even while the level of Bank Rate itself remains a fraction of the pre-crisis norm (see Chart 53).

Chart 53: The typical market reaction to MPC meeting announcements appears to be an upward trend



Source: Bank of England, Santander.
Note: Chart shows a rolling 12-meeting average value of the market reaction on MPC meeting days, based on 2-year OIS data.

UK Rates Strategy: Brace for fiscal and monetary tightening

Adam Dent
(+44) 207 756 6223

- **We are bearish on UK rates following the market's very dovish interpretation of November's Bank Rate hike**
- **We see the 5y point as particularly vulnerable to hawkish nudges from the MPC, with hardly any risk premium in the short curve**
- **In contrast, the market continues to fear the worst for the gilt remit at the coming Budget, but we expect the Chancellor to continue prioritizing fiscal discipline**
- **We see plenty of room for long gilts to perform well afterwards, especially on ASW and evidence of ample demand in the market**

Expect more tightening talk, if not action, from the MPC

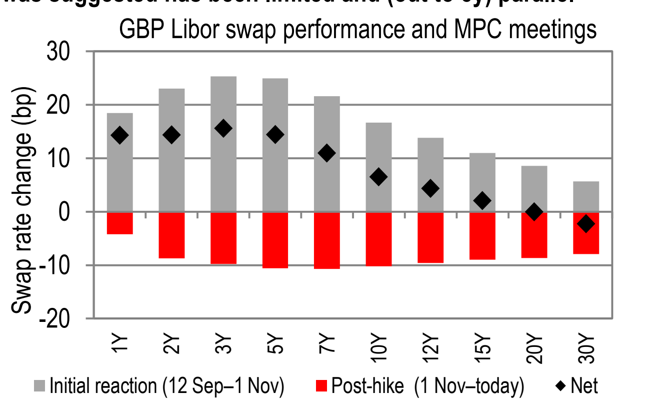
The market interpreted the BoE's long-awaited rate hike as coming with dovish implications for the future, as explained in the UK Economics section above. 3-5y tenors had led the GBP swap sell-off since the MPC raised the prospect of imminent hikes at the September meeting, but the partial reversal once the hike was actually delivered was rather more parallel (Chart 54).

Our central scenario is that this hike will prove to be 'one and done', based on our forecasts that headline inflation cools off and fails to trigger an acceleration of wage growth. However, even if we are correct, it will take a few more months for this to become evident. In the meantime, the BoE's own models will continue to warn of domestic inflationary pressures that need offsetting monetary policy action.

We believe there is some consensus within the MPC that further tightening is likely to be needed, even though this is no longer spelt out as explicit forward guidance in the minutes. The hike was intended as marking the beginning of a "limited and gradual" cycle, not a one-off unwind of last summer's cut. Governor Carney implied this at November's Inflation Report press conference, and Deputy Governor Broadbent made the point more explicitly in a BBC interview the next day, although the market disregarded both messages.

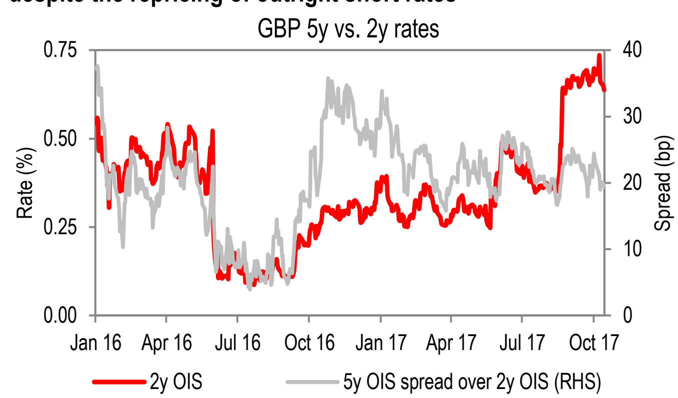
We are bearish on UK rates in general here, both on concerns that the BoE will become more vocally hawkish and that the recent outperformance vs. other markets, on which we are even more bearish, will be hard to sustain.

Chart 54: The sell-off across the UK rates curve since the hike was suggested has been limited and (out to 5y) parallel



Source: Bloomberg, Santander.

Chart 55:UK rate slopes have remained firmly range-bound despite the repricing of outright short rates



Source: Bloomberg, Santander.

Trade idea: GBP 2s5s OIS steepener. Enter at 19.6bp, target 24bp with a stop at 17bp. Libor swaps would be a close substitute.

The parallel shape of the sell-off means there is still very little risk premium in the front of the curve. 2s5s is at its flattest since the September MPC meeting and just 3bp from its lowest in over a year (Chart 55). We believe this under-prices for the chance that the MPC will up its rhetoric on further tightening, with the market having to go through the experience of August/September again (see UK Economics).

Regressing the 5y OIS on 2y suggests the slope is 3.3bp too flat. A 2s5s steepener has slightly positive carry and roll-down (0.5bp and 0.7bp, respectively, over a 3m horizon), so a 'no news' outcome should not hurt.

We prefer OIS rates for this analysis as the marked FRA-OIS basis tightening this year distorts the history of very short-tenor Libor-based swaps, a phenomenon which we believe will persist (as explored in publications on 2 August and 27 September). This liquidity and/or credit effect steepens the GBP Libor curve relative to underlying risk-free rate expectations. If these basis spreads broadly remain in their new, tighter ranges, as we expect, this would cloud the analysis but would not necessarily argue for expressing the resulting trades in either Sonia or Libor.

However, we have a bias towards further tightening of the 5-10y FRA-OIS basis based on the implications of the coming migration from Libor to Sonia as the UK's primary near Risk-Free Reference Rate (RFR), as explained in those articles referenced earlier. The very short basis, on the other hand, is so tight already that we find there is little scope to go further (2y 3s-OIS <10bp), so its near-term risks could have an upward bias. At the margin, this suggests OIS swaps would be a better steepener expression, even though the roll-down is slightly more favourable using Libor swaps (an extra 0.5bp/3m).

The Chancellor looks likely to continue (attempting) his own fiscal tightening

The focus is now moving from monetary to fiscal policy, ahead of the Autumn Budget on 22 November. There has been much market and media speculation around a "giveaway" Budget and the potential for a major spending boost to prepare for Brexit (particularly its 'harder' variants), but we believe this is largely ill-founded.

For details, please refer to our UK Fiscal Update, *Approaching an issuance 'sweet spot'?*, of 25 October. In short, we see three reasons to expect lower borrowing targets –both this year and in coming years– and a gilt-supportive Budget:

- **Cash requirements so far this year are beating expectations**
- **The current fiscal framework is too new to materially rewrite**
- **Supply-side forecast revisions would reduce scope for borrowing**

If current market expectations of some fiscal loosening are confounded, longer-dated gilts should feel the most benefit (from reduced supply flows, better fiscal sustainability and less inflationary pressure). On a more tactical view, this quarter's gilt supply calendar is very light, and we see very little room for ultra-long nominal supply until next fiscal year's syndications (one 40-50y auction next quarter is all that seems likely).

Outright gilt flatteners in the long end appeal to us, and would also benefit from the bearish international influences that we anticipate and that historically have the greatest impact on 5-10y gilt yields. Accordingly, we maintain our beta-weighted 10s30s gilt flattener recommendation from 23 July, which has been hovering 1-2bp onside for a while, but we believe it can go further. For new entrants, we would suggest a DV01-neutral expression, rather than the 85% 10y weighting that we proposed in the original, more bullish environment.

Gilt spreads would provide a less directional way to play for a cautious Budget. Spreads at both very short and long maturities have been weak recently, while 5y and 10y performed relatively well both before and after the BoE's hike (Chart 56).

Trade idea: Buy UKT 45s vs. 0H 22s on ASW. Enter at 66.5bp, target 60bp, stop at 68bp (quoted as yield/yield vs. 6m £ Libor)

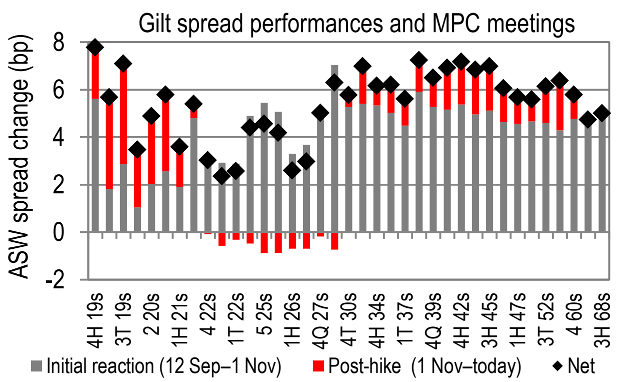
The lack of ultra-long supply opportunities suggests looking at the longest gilts, but this is already somewhat priced in: the 30s50s curve of −21bp is near its all-time extremes, and the ASW box is almost as low outright (−19.5bp) and even more so by its own historical standards.

In the front end, the 0H 22s stands out as rich after a very strong period since coming off-the-run, which should run out of steam eventually. At the far end, the 45s or 47s are relative underperformers on ASW and, to a lesser extent, in yield terms. We suggest the 45s because it has the tightest spread on the curve and also because our 10s30s flattener already uses the 47s. We find the box is 3-4bp too wide on regressions, although the relationship is not very strong (82% R^2 over 12m, but just 45% over the last 3m). The box is at its steepest for months, perhaps influenced by this week's 30y linker syndication (Chart 57).

Short spreads are fairly directional, more so than longs (~50% and 35% yield-spread correlations for 5y and 30y, respectively), but the box itself has weak correlations with both the level and slope of yields (-20% and 24%). We interpret this as showing that the spread box separates gilt supply/demand dynamics from broader macro drivers of rates and the curve, and believe this idea is not redundant when combined with the 2s5s (and 10s30s) curve views.

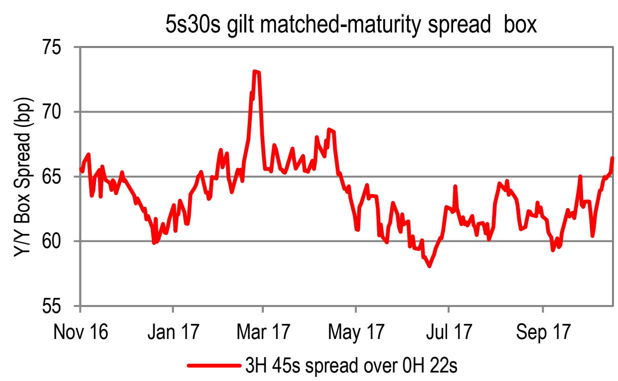
For liquidity investors, or those who are less bearish on medium gilts, we would simply suggest shifting ASW positions towards longer (ideally 30y) maturities.

Chart 56: Gilt spreads steepened in anticipation of the hike, and have butterflied since it happened (4-10y outperformed)



Source: Bloomberg, Santander.

Chart 57: The 5s30s gilt spread curve is at its steepest for six months



Source: Bloomberg, Santander.

Stuart Bennett
(+44) 20 7756 4136

USD – Too cheap

We believe that, in general, the USD has been oversold. We still expect the USD to be firm in 2018. The Fed remains on course to hike rates in December, with further hikes likely coming in 2018. Further, we expect both US GDP growth and inflation to be higher than its developed market peers'.

As expected, the FOMC kept policy unchanged at its November meeting. Whilst below-target inflation is likely to remain a concern, the Fed remains on course to hike in December, and the November meeting did not affect the market's perceived probability of this, which still stands at over 90%. The prospect of a near-term rate hike is unlikely to be affected by President Trump's nomination of Jerome Powell as the next Fed Chair.

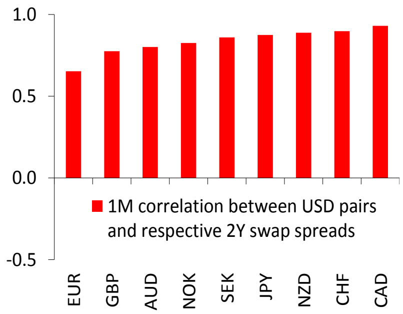
The risk of slower inflation may raise doubts over the pace of tightening next year, but we forecast that US CPI will rise to 2.5% in 2018. But, even if it is lower, as we have highlighted before, lower US inflation would probably imply slower Eurozone/G10 inflation. And that, in turn, could mean that other central banks delay withdrawing their monetary accommodation, which should imply the USD could be stronger against their currencies.

Currently, the USD/G10 pairs are all highly correlated with their respective 2Y spreads. As such, a December rate hike should imply a stronger USD. Further, given that we estimate that the USD index is on the cheap side for the current US 10Y yield, we find it has scope to appreciate into the end of the year.

The consensus still expects 10Y yields to rise next year across developed markets, with the exception of Japan. The increase in US 10Y yields is expected to be slightly bigger than that of its peers'.

Hence spreads should be USD supportive, particularly against the Yen (see "Fed-BoJ trade-off should still favour USD/JPY upside", published 18 September) and, whilst not a reason in itself to buy the USD aggressively across the board, it should be sufficient to prevent notable USD weakness in to 2018.

Chart 58: If the Fed hikes, as expected, USD should appreciate against its G10 peers



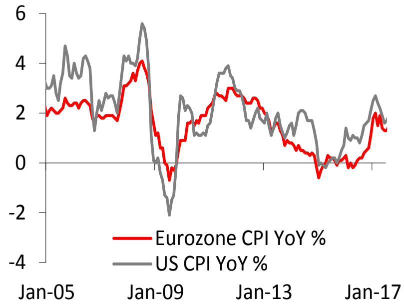
Source: Bloomberg, Santander

Table 13: G10 FX forecasts

	Q4 17	Q1 18	Q2 18	Q3 18	Q4 18	Q1 19
EUR-USD	1.14	1.15	1.17	1.18	1.20	1.22
GBP-USD	1.32	1.3	1.28	1.26	1.25	1.25
GBP-EUR	1.16	1.13	1.09	1.07	1.04	1.02
EUR-GBP	0.86	0.88	0.91	0.94	0.96	0.98
USD-JPY	114	116	118	119	120	122
EUR-JPY	130	133	138	140	144	149
EUR-CHF	1.12	1.14	1.14	1.16	1.20	1.22
USD-CHF	0.98	0.99	0.97	0.98	1.00	1.00
EUR-SEK	9.5	9.4	9.3	9.1	9.0	8.8
EUR-NOK	9.2	9.2	9.1	9.1	9.0	8.9
USD-CAD	1.25	1.25	1.24	1.24	1.22	1.22
AUD-USD	0.76	0.76	0.74	0.75	0.77	0.79
NZD-USD	0.70	0.70	0.69	0.71	0.73	0.75

Source: Bloomberg, Santander

Chart 59: Any Fed concerns about inflation should eventually spread to other CBs



Source: Bloomberg, Santander

Plus, the economic outlook also appears USD supportive. Whilst the impact of the recent hurricanes is seen distorting economic data, the US economy is still expected to perform well through to the end of 2018. The IMF expects the US to grow 2.2% in 2018, compared to the 2% average forecast for advanced economies as a whole.

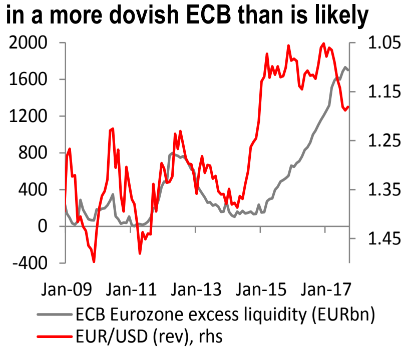
As such, in our opinion, the FX market's short USD positioning looks vulnerable to short covering in the months ahead. Indeed, this process may already have begun. IMM data indicate that the net short USD position (including MXN) at the end of September was at its highest since January 2013. However, some of these short positions were reversed during October.

Admittedly, the USD may still come under pressure from lower risk appetite, be that focusing on North Korea or Trump etc.. But, the market has seemed to be less willing to 'panic' in response to these issues recently. Indeed, a period of US/global political stability would be another factor supporting the USD.

Moreover, with some uncertainty surrounding European politics and the Brexit process remaining, and Italian elections due in May 2018, the market could easily reach the conclusion that the risk baton has moved back toward Europe, encouraging profit-taking on the EUR/USD rally since May 2017, again, supporting the USD.

EUR – Pinned down by spreads

Chart 60: EUR/USD may have priced in a more dovish ECB than is likely



Source: Bloomberg, Santander

We remain positive about the EUR into 2018, but still feel that it may be slightly too expensive currently, with scope to soften in Q4-17. The Eurozone economy is robust and the ECB is expected to adopt an increasingly more optimistic stance, but policy changes should be gradual, with the first ECB rate hike not expected until early 2019.

The Eurozone economic recovery remains a support for the EUR. We expect the economy to grow by 2% in 2017 and 2.2% in 2018. High frequency data continue to improve, and economic confidence reached its highest level in August since June 2007.

Better than expected data is shoring up the market's positive sentiment toward the EUR. However, in relative terms, data have also been performing well for other G10 economies, including the US and the UK. For example, we continue to expect the US to outgrow the Eurozone in 2017 and 2018, which, as a backdrop, should temper the market's appetite to be too long EUR/USD.

The monetary policy outlook should also provide reason for caution about adopting too positive a stance on EUR/USD. In October, the ECB announced that it would extend its QE programme beyond December 2017, to, at least September 2018. However, it will halve its monthly purchases to EUR30bn.

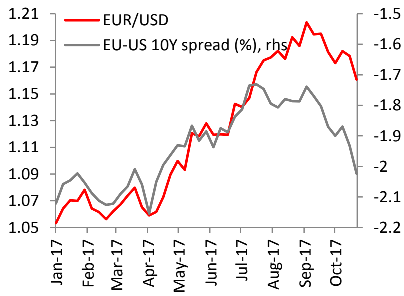
The additional QE implies that the ECB's balance sheet and excess liquidity measure should remain high. In essence, a lot of EUR will continue to flush their way through the system, which should imply a cheaper EUR, everything else equal, and, at the very least, should temper the market's appetite to buy the currency aggressively in H1-18.

Plus, remember that this will be happening at the same time that we believe the Fed will be pushing ahead with its plan to shrink its balance sheet, albeit slowly.

In addition, we do not expect the ECB to hike rates until March 2019 at the earliest, by which time we forecast that the Fed will have hiked four times, starting in December 2017. Such policy divergence should be EUR-negative, but the outlook for EU-US yields suggests a more stable currency pair.

In "EUR/USD yielding too much ahead of the ECB", published 5 September, we argued that EUR/USD could be seen as already having appreciated too

Chart 61: EUR/USD looking expensive given yield spreads and possible G10 monetary policy changes may not help either



Weekly data
Source: Bloomberg, Santander

far, given the current developments in EUR-USD 10Y spreads. This over-valuation persists, albeit to a lesser extent.

The 10Y spread is historically a good indicator for EUR/USD. It currently stands at -2% and, in line with the market, we expect the spread to end 2017 at -1.8%, but finish 2018 back at -2%. Hence, the outlook for yields suggests little pressure on the pair to move massively, in either direction, over the coming months.

Pockets of low risk appetite, whether focusing on US or European politics, North Korea or China will provide market opportunities in EUR/USD and other EUR crosses, but the yields backdrop suggest that big directional moves, particularly to the upside, are unlikely.

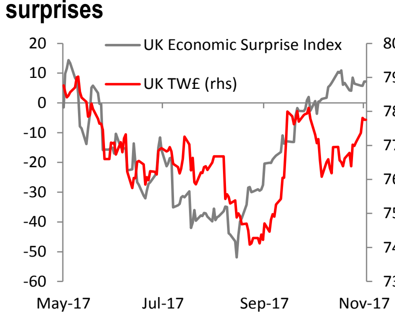
Thus, with the speculative market very long EUR/USD and favouring further gains, the risks we see is that the realisation that the pair has stalled will encourage an unwinding of these positions, even before the end of the year, and encourage EUR/USD back toward 1.15 levels.

GBP – Unimpressed by a 'dovish' hike

We still believe that Sterling remains vulnerable to the downside. The MPC's 'dovish hike' in November has not offered support. We would still argue that the Pound has been oversold in relation to UK fundamentals over the last year or so. However, uncertainty surrounding Brexit does not appear likely to disappear soon. Hence, we still favour a downside bias for Sterling in 2018.

Sterling posted significant monthly changes during August and September, as Trade-weighted Sterling first declined 3%, but then rebounded 5.2%. To put this into context, August's 3% decline was the tenth-biggest monthly fall over the last ten years. In addition, note that many of the bigger monthly declines are associated with, and can be easily justified by, big risk events, such as QE, the credit crisis and the Brexit vote.

Chart 62: Sterling and UK data surprises



Source: Citi, Bloomberg, Santander

Further, September's move was the second-biggest monthly gain in the TW£ not only over the last ten years, but since 1990. The swings in the Pound over the last couple of months may indicate a currency that is struggling to find a clear lead. As evidence of this, the trade-weighted Pound ended October virtually unchanged from its position at the start of the month.

As expected, the BoE hiked its benchmark rate 25bp to 0.5% at its November meeting. The increase was the first for over a decade, and, as such, is symbolically very important. Since mid-September, MPC members had been warning that a hike was probable, supporting the Pound.

However, the market interpreted the move as a 'dovish' hike and the Pound slumped in its immediate aftermath. Further, the Minutes did not include any suggestion, as they previously had, that more hikes than the market currently expects may be required.

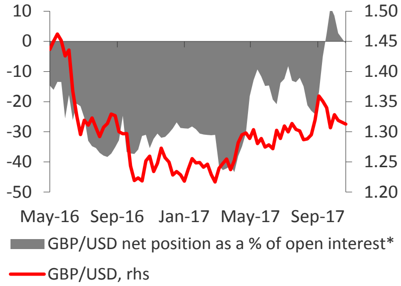
Hence, it appears that the BoE is content with current expectations for further rate hikes, which do not envisage the next hike coming until late 2018. This outlook, in our opinion, is not sufficiently hawkish to imply that the Pound will strengthen on interest rate dynamics through to the end of the year, especially with the Fed expected to hike US rates in December.

Further, we still expect the UK economy to underperform both the US and Eurozone. Plus, we forecast UK CPI (3.0% in September) will slow. The expected underperformance of the UK economy, versus its peers, should also prevent any sharp rebound in the Pound.

We expect the UK economy to grow 1.6% in 2017 and 1.4% in 2018, whereas Eurozone growth is seen at 2% and 2.2%, with the US at 2.2%

and 2.8%, respectively. Hence, it will perhaps require a big improvement in UK activity to encourage the market to further unwind its sell-off since mid-2016.

Chart 63: Speculators long GBP/USD



* OI=Total long and short contracts
Source: Bloomberg, Santander

With rate expectations likely to have less effect on the currency over the coming months, economic data should become an even more important driver of the Pound. Indeed, the move in TW£ since May seems to have mimicked the UK's economic surprise index.

In addition, we still view the Brexit uncertainty as a downside risk to the Pound. The UK's negotiations with the EU do not appear to be advancing as quickly as many had hoped. Plus, doubts over PM May's ability to hold on to her job have also resurfaced recently, adding to pressure on the Pound.

Admittedly, the IMM non-commercial position did show that speculators adopted a net long GBP/USD position in October (for the first time since September 2014). But, this slipped back quickly. Further, whilst the overall change implies that this part of the market is more relaxed about the GBP outlook, it also means that fast money accounts now have ammunition to bet against Sterling again, if Brexit talks turn sour and sentiment deteriorates.

Euro interest rate forecasts

Government Bond yield Forecasts

Bunds	Current	4Q17	1Q18	2Q18	3Q18	4Q18
ECB Depo	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40
3m	-0.78	-0.70	-0.70	-0.70	-0.60	-0.55
2y	-0.76	-0.70	-0.45	-0.30	-0.15	0.05
5y	-0.39	-0.30	0.00	0.15	0.35	0.55
10y	0.32	0.45	0.70	0.95	1.10	1.25
30y	1.20	1.30	1.55	1.75	1.85	1.90

Swap rate forecasts

€ swaps	Current	4Q17	1Q18	2Q18	3Q18	4Q18
ECB Depo	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40
3m	-0.33	-0.33	-0.33	-0.28	-0.23	-0.13
2y	-0.21	-0.15	0.05	0.15	0.25	0.40
5y	0.17	0.25	0.45	0.60	0.75	0.90
10y	0.81	0.90	1.15	1.35	1.50	1.60
30y	1.53	1.60	1.85	2.00	2.10	2.15

US interest rate forecasts

Government Bond yield Forecasts

USTs	Current	4Q17	1Q18	2Q18	3Q18	4Q18
FOMC (mid)	1.125	1.375	1.375	1.625	1.875	2.125
3m	1.22	1.20	1.35	1.60	1.90	2.15
2y	1.63	1.80	2.10	2.40	2.70	3.00
5y	1.99	2.20	2.50	2.75	3.00	3.20
10y	2.31	2.55	2.90	3.10	3.30	3.50
30y	2.77	2.95	3.15	3.30	3.45	3.60

Swap rate forecasts

$ swaps	Current	4Q17	1Q18	2Q18	3Q18	4Q18
FOMC (mid)	1.125	1.375	1.375	1.625	1.875	2.125
3m	1.41	1.40	1.55	1.80	2.10	2.35
2y	1.84	2.00	2.30	2.60	2.90	3.20
5y	2.06	2.25	2.55	2.80	3.05	3.25
10y	2.29	2.55	2.90	3.10	3.30	3.50
30y	2.51	2.70	2.90	3.05	3.20	3.35

UK Interest rate forecasts

Government Bond yield Forecasts

Gilts	Current	4Q17	1Q18	2Q18	3Q18	4Q18
MPC	0.50	0.50	0.50	0.50	0.50	0.50
3m	0.45	0.45	0.40	0.37	0.37	0.42
2y	0.44	0.50	0.70	0.50	0.35	0.40
5y	0.68	1.00	1.25	0.90	0.80	0.90
10y	1.20	1.30	1.60	1.40	1.30	1.50
30y	1.78	2.00	2.30	2.10	1.80	2.00

Swap rate forecasts

£ swaps	Current	4Q17	1Q18	2Q18	3Q18	4Q18
MPC	0.50	0.50	0.50	0.50	0.50	0.50
3m	0.53	0.55	0.55	0.52	0.52	0.52
2y	0.79	0.90	1.10	0.80	0.70	0.80
5y	1.01	1.30	1.50	1.15	1.15	1.20
10y	1.27	1.35	1.60	1.50	1.40	1.55
30y	1.48	1.70	1.95	1.70	1.40	1.60

FX forecasts

	Current	4Q17	1Q18	2Q18	3Q18	4Q18
EUR-USD	1.160	1.14	1.15	1.17	1.18	1.20
EUR-GBP	0.886	0.86	0.88	0.91	0.94	0.96
GBP-USD	1.200	1.32	1.30	1.28	1.26	1.25
USD-JPY	113.5	114	116	118	119	120
EUR-JPY	131.7	130	133.4	138.1	140	144

	Current	4Q17	1Q18	2Q18	3Q18	4Q18
NZD-USD	0.693	0.70	0.70	0.69	0.71	0.73
USD-CAD	1.273	1.25	1.25	1.24	1.24	1.22
AUD-USD	0.768	0.76	0.76	0.74	0.75	0.77
EUR-CHF	1.160	1.12	1.14	1.14	1.16	1.20
EUR-SEK	9.73	9.5	9.4	9.3	9.1	9.0
EUR-NOK	9.47	9.2	9.2	9.1	9.1	9.0

IMPORTANT DISCLOSURES

ANALYST CERTIFICATION:

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

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

G-10 Rates, Macro & FX Strategy

Antonio Villarroya	Head of Macro & Strategy Research	antvillarroya@gruposantander.com	(+34) 91 257-2244
Luca Jellinek	Head of Rates and FX Strategy	luca.jellinek@santandergcb.com	(+44) 20 7756 4111
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@santandergcb.com	(+44) 20 7756 6170
Adam Dent	UK Rates Strategy	adam.dent@santandergcb.com	(+44) 20 7756 6223
Stuart Bennett	G10 FX Strategy	stuart.bennett@santandergcb.com	(+44) 20 7756 4136
Michael Flisher	G10 FX Strategy	michael.flisher@santandergcb.com	(+44) 20 7756 5799
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).

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

NOTE: Given the recent volatility seen in the financial markets, the recommendation definitions are only indicative until further notice.
We generally review our Rates/FX recommendations monthly, in our regular Interest & Exchange and FX Compass publications, and when market events/moves so warrant.

Comprehensive disclosures for all G-10 Rates, Macro & FX Strategy/research produced by Banco Santander, S.A. can be found on our website.

IMPORTANT DISCLOSURES

This report has been prepared by Banco Santander, S.A. and is provided for information purposes only. Banco Santander, S.A. is registered in Spain and is authorised and regulated by Banco de España, Spain.

This report is issued in the United States by Santander Investment Securities Inc. ("SIS"), in Spain by Banco Santander, S.A., under the supervision of the CNMV and in the United Kingdom by Banco Santander, S.A., London Branch ("Santander London"). SIS is registered in the United States and is a member of FINRA. Santander London is registered in the United Kingdom (with FRN 136261, Company No. FC004459 and Branch No. BR001085), and subject to limited regulation by the UK's Financial Conduct Authority ("FCA") and Prudential Regulation Authority ("PRA"). SIS, Banco Santander, S.A. and Santander London are members of Santander Group. A list of authorised legal entities within Santander Group is available upon request.

This material constitutes "investment research" for the purposes of the Markets in Financial Instruments Directive and as such contains an objective or independent explanation of the matters contained in the material. Any recommendations contained in this document must not be relied upon as investment advice based on the recipient's personal circumstances. The information and opinions contained in this report have been obtained from, or are based on, public sources believed to be reliable, but no representation or warranty, express or implied, is made that such information is accurate, complete or up to date and it should not be relied upon as such. Furthermore, this report does not constitute a prospectus or other offering document or an offer or solicitation to buy or sell any securities or other investment. Information and opinions contained in the report are published for the assistance of recipients, but are not to be relied upon as authoritative or taken in substitution for the exercise of judgement by any recipient, are subject to change without notice and not intended to provide the sole basis of any evaluation of the instruments discussed herein.

Any reference to past performance should not be taken as an indication of future performance. This report is for the use of intended recipients only and may not be reproduced (in whole or in part) or delivered or transmitted to any other person without the prior written consent of Banco Santander, S.A..

Investors should seek financial advice regarding the appropriateness of investing in financial instruments and implementing investment strategies discussed or recommended in this report and should understand that statements regarding future prospects may not be realised. Any decision to purchase or subscribe for securities in any offering must be based solely on existing public information on such security or the information in the prospectus or other offering document issued in connection with such offering, and not on this report.

The material in this research report is general information intended for recipients who understand the risks associated with investment. It does not take into account whether an investment, course of action, or associated risks are suitable for the recipient. Furthermore, this document is intended to be used by market professionals (eligible counterparties and professional clients but not retail clients). Retail clients must not rely on this document.

To the fullest extent permitted by law, no Santander group company accepts any liability whatsoever (including in negligence) for any direct or consequential loss arising from any use of or reliance on material contained in this report. All estimates and opinions included in this report are made as of the date of this report. Unless otherwise indicated in this report there is no intention to update this report.

Banco Santander, S.A. and its legal affiliates (trading as Santander and/or Santander Global Corporate Banking) may make a market in, or may, as principal or agent, buy or sell securities of the issuers mentioned in this report or derivatives thereon. Banco Santander, S.A. and its legal affiliates may have a financial interest in the issuers mentioned in this report, including a long or short position in their securities and/or options, futures or other derivative instruments based thereon, or vice versa.

Banco Santander, S.A. and its legal affiliates may receive or intend to seek compensation for investment banking services in the next three months from or in relation to an issuer mentioned in this report. Any issuer mentioned in this report may have been provided with sections of this report prior to its publication in order to verify its factual accuracy.

Banco Santander, S.A. and/or a company in the Santander group is a market maker or a liquidity provider for EUR/GBP, EUR/JPY and EUR/USD.

Banco Santander, S.A. and/or a company of the Santander group has been lead or co-lead manager over the previous 12 months in a publicly disclosed offer of or on financial instruments of the UK Debt Management Office.

ADDITIONAL INFORMATION

Banco Santander, S.A. or any of its affiliates, salespeople, traders and other professionals may provide oral or written market commentary or trading strategies to its clients that reflect opinions that are contrary to the opinions expressed herein. Furthermore, Banco Santander, S.A. or any of its affiliates' trading and investment businesses may make investment decisions that are inconsistent with the recommendations expressed herein.

No part of this report may be copied, conveyed, distributed or furnished to any person or entity in any country (or persons or entities in the same) in which its distribution is prohibited by law. Failure to comply with these restrictions may breach the laws of the relevant jurisdiction.

Investment research issued by Banco Santander, S.A. is prepared in accordance with the Santander group policies for managing conflicts of interest. In relation to the production of investment research, Banco Santander, S.A. and its affiliates have internal rules of conduct that contain, among other things, procedures to prevent conflicts of interest including Chinese Walls and, where appropriate, establishing specific restrictions on research activity. Information concerning the management of conflicts of interest and the internal rules of conduct are available on request from Banco Santander, S.A..

COUNTRY & REGION SPECIFIC DISCLOSURES

U.K. and European Economic Area (EEA): Unless specified to the contrary, issued and approved for distribution in the U.K. and the EEA by Banco Santander, S.A. Investment research issued by Banco Santander, S.A. has been prepared in accordance with Grupo Santander's policies for managing conflicts of interest arising as a result of publication and distribution of investment research. Many European regulators require that a firm establish, implement and maintain such a policy. This report has been issued in the U.K. only to persons of a kind described in Article 19 (5), 38, 47 and 49 of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (all such persons being referred to as "relevant persons"). This document must not be acted on or relied on by persons who are not relevant persons. Any investment or investment activity to which this document relates is only regarded as being provided to professional investors (or equivalent) in their home jurisdiction. **United States of America (US):** This report is being distributed to US persons by Santander Investment Securities Inc ("SIS") or by a subsidiary or affiliate of SIS that is not registered as a US broker dealer, to US major institutional investors only. Any US recipient of this report (other than a registered broker-dealer or a bank acting in a broker-dealer capacity) that would like to effect any transaction in any security or issuer discussed herein should contact and place orders in the United States with the company distributing the research, SIS at (212) 692-2550, which, without in any way limiting the foregoing, accepts responsibility (solely for purposes of and within the meaning of Rule 15a-6 under the US Securities Exchange Act of 1934) under this report and its dissemination in the United States. US recipients of this report should be advised that this research has been produced by a non-member affiliate of SIS and, therefore, by rule, not all disclosures required under NASD Rule 2711 apply. **Hong Kong (HK):** This report is being distributed in Hong Kong by a subsidiary or affiliate of Banco Santander, S.A. Hong Kong Branch, a branch of Banco Santander, S.A. whose head office is in Spain. The 1% ownership disclosure satisfies the requirements under Paragraph 16.5(a) of the Hong Kong Code of Conduct for persons licensed by or registered with the Securities and Futures Commission, HK. Banco Santander, S.A. Hong Kong Branch is regulated as a Registered Institution by the Hong Kong Monetary Authority for the conduct of Advising and Dealing in Securities (Regulated Activity Type 4 and 1 respectively) under the Securities and Futures Ordinance. The recipient of this material must not distribute it to any third party without the prior written consent of Banco Santander, S.A. **Japan (JP):** This report has been considered and distributed in Japan to Japanese-based investors by a subsidiary or affiliate of Banco Santander, S.A. - Tokyo Representative Office, not registered as a financial instruments firm in Japan, and to certain financial institutions defined by article 17-3, item 1 of the Financial Instruments and Exchange Law Enforcement Order. Some of the foreign securities stated in this report are not disclosed according to the Financial Instruments and Exchange Law of Japan. There is a risk that a loss may occur due to a change in the price of the shares in the case of share trading and that a loss may occur due to the exchange rate in the case of foreign share trading. **China (CH):** This report is being distributed in China by a subsidiary or affiliate of Banco Santander, S.A. Shanghai Branch ("Santander Shanghai"). Santander Shanghai or its affiliates may have a holding in any of the securities discussed in this report; for securities where the holding is greater than 1%, the specific holding is disclosed in the Important Disclosures section above.

For further country and region specific disclosures please refer to Banco Santander, S.A..

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**	**Tokyo**
Tel: 32 2 286 5447	Tel: 33 15353 7000	Tel: 49 6959 67-6403	Tel: 813-5561-0591
Fax: 32 2 230 6724	Fax: 33 15353 7060	Fax: 49 6959 67-6407	Fax: 813-5561-0580
New York	**Bogota**	**Buenos Aires**	**Caracas**
Tel: 212-756-9160	Tel: 571-644-8008	Tel: 54114-341-1052	Tel: 582-401-4306
Fax: 212-407-4540	Fax: 571-592-0638	Fax: 54114-341-1226	Fax: 582-401-4219
Lima	**Mexico DF**	**Santiago de Chile**	**São Paulo**
Tel: 511-215-8133	Tel: 525-629-5040	Tel: 562-336-3300	Tel: 5511-3012-5721
Fax: 511-215-8161	Fax: 525-629-5846	Fax: 562-697-3869	Fax: 5511-3012-7368