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Interest & Exchange

Understandable concerns, but no fundamental changes

Global Strategy: Despite the healthy macro environment, the feeling that upward growth revisions might be behind, geopolitical and name-specific uncertainties and the aim of protecting the returns provided by risky assets in recent years have all increased investors' concerns, taking some chips off their risky asset allocations. This sentiment shift has benefited global rates. We are not negative risky assets and expect 10y USTs to break the 3% level later this year. But, tactically, we think this move can continue in coming weeks..

US Macro: The Fed raised its US GDP forecasts last month, but acknowledged that the economic performance could be weaker in the short run. The 1Q18 hard economic data have been weaker than in 4Q17 and could point to lower GDP growth rates. Although the 1Q18 numbers might not be as good as expected, we believe that leading business confidence indicators signal much stronger growth during the rest of the year. We maintain our positive GDP forecasts for 2018-19.

US Rates: The recent downward correction in US rates fits perfectly with the scenario we were expecting and, at these levels, we are taking profits in our tactical positioning (receive the belly in 5s10s30s). We continue to think that the medium-term trend is for higher US rates, but the risk of an imminent sell-off in US rates is still limited. Therefore, we now prefer to focus on carry-efficient alternatives to be short the belly (like paying the belly in 2s5s10s).

EUR Macro: Euro zone GDP growth beat expectations, supported by the improvement in fundamentals for domestic demand and the surge in exports. We have updated our growth forecasts accordingly and continue thinking it can also deliver very good results in 2018 and 2019, putting special attention on the performance of investment, salaries and core inflation.

EUR Rates: Weaker stocks, leading indicators and slow inflation have helped EUR core rates correct lower, erasing roughly 50% of the preceding sell-off. Tighter policy, medium term, suggests higher rates but at a slow pace, like in 2017. We suggest positioning against some interesting yield curve dislocations that should not be exceedingly directional. Political and policy risk in Italy remains elevated, despite tighter BTP-Bund spreads. We like the 15y SPGB area.

GBP Macro: UK CPI surprised to the downside in February, reaching the lowest level since July 2017. We believe that the factors behind this decline are key to the monetary policy discussion and that consumer price inflation is now set to fall below the 2% target before end-2018, and argue that an acceleration of wage pressures is increasingly required to prevent an inflation undershoot through 2019.

GBP Rates: The UK has tracked bullish corrections in other long-term rates markets, but pricing for an imminent Bank Rate hike has stood out as an unusually constant and perhaps complacent feature of the market. We still recommend steepeners (e.g. 1s5s OIS), anticipating challenges to the market's 'two-and-done' view. We also consider the recent FRA-OIS spread widening in the UK, which we believe is more likely to prove sustainable in long rather than short, US-led tenors.

G-10 FX: Selling USDs seems to remain the FX market's default position, but we still think that it has adopted too negative a stance on the currency. The EUR has stayed firm over the last month, but has not been able to push above its 2018 high. Good economic data continue to provide support, but no longer appear sufficient to pull the currency higher. GBP remains relatively firm, but we still believe that the Pound should remain vulnerable.

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) 33 114 80 133 / 239 / 240

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) 33 114 80 134 / 232

For a full list of contributors, please refer to page 35

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

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	USD	EUR	GBP
Economic Outlook	We estimate GDP at 2.2% in 2017, 2.5% in 2018 and 2.6% in 2019, helped by private consumption and investment. Growth could smoothen in the short term, but should then recover.	Given stronger-than-expected external trade dynamics and sound domestic demand, we revise our GDP estimates to +2.4% for 2018E (vs +2.2%) and +2.2% in 2019E (vs +2.1%). All four major countries to contribute positively.	We expect UK GDP growth to remain at a c. 1.5% pace in 2018, with investment constrained by ongoing Brexit uncertainty. Falling inflation should boost reported consumption growth in 2H18.
Monetary Policy / Front-End	We maintain our long-held call of three 25bp hikes from the Fed in 2018, with an eye on core inflation, wages and DXY. Upside risk.	We expect the ECB to continue buying bonds (€30bn/mth) until Sep'18, followed by a small tapering in 4Q18, with the first rate hike around mid-2019. Watch the EUR.	We expect Bank Rate to remain at 0.5% through 2018 and no change in QE, but anticipate hawkish commentary from the MPC continuing, driven by concerns around falling spare capacity.
Rates / Duration	The monetary policy normalization , healthy macro environment and potential changes in supply/demand equilibrium should weigh on USTs all along the curve.	Core rates are still very low and should rise over the course of 2018, as the ECB points toward tighter policy. Recent macro figures and flows, however, suggest limited upside, near term.	The market's conviction on pricing for two UK hikes within the next year still looks too aggressive to us, given the macro context.
Curve / Slope	We remain bearish the front end (pay 2y2y) but think the risk of an imminent sell-off in the belly is limited. Play carry-efficient shorts (pay the belly in 2s5s10s).	Curve slope/direction relationships are shifting, as the policy cycle turns. We like steepeners like 10f5y-5f5y and barbells like 5—7-20y.	UK curves are unduly flat at all tenors at this stage of a supposed hiking cycle, and we see more risk premium as warranted. 5s10s looks particularly extreme.
Spreads	Gradually unwinding SOMA reinvestments pose a risk for USTs. We like swap spread wideners (bearish USTs), especially in the ultra-long end.	Economic recovery, further ratings upgrades and decelerating supply underpin SPGBs. BTPs seem optimistically priced relative to the election results.	Gilt spread widening could go further towards fiscal year-end, but we believe the limits will soon be seen. The front of the ASW curve looks too flat, like outright rates.
Volatility	Long expiries of short maturities look cheap, both when compared to delivered and vs recent market ranges. The top-left corner, on the contrary, looks slightly rich.	The spike in EUR swaption-implied vols proved short-lived due to moderate data and ECB dovishness. Near all-time lows, however, it now looks cheap.	Implied vols towards the top-left have stabilized off their lows. But long tenors, in particular, still look too sedate for the secular economic uncertainty in the UK.
Inflation / Break-evens	Concerns about accelerating inflation might return when equities stabilize. We see the recent correction as an opportunity to reload longs in breakevens.	Though very gradually, ex-tobacco y/y inflation is rising again and should place a floor under current 5y and 10y ILS levels (1.35% - 1.5%).	A decline in CPI is now well under way, but the sharpest falls (to 2%) may be delayed until H2. Wage growth remains pivotal, but UK labour data is noisy.
FX	The USD remains relatively weak, with political and trade concerns weighing on the currency. The mix of a strong economy and further Fed rate hikes in 2018 should provide support.	EUR/USD gains still look a bit excessive, though economic data have been strong and supportive. The ECB's status quo stance and wider US-EU yields should weigh eventually, but for now are being ignored.	Sterling has been firm, but much of the GBP/USD rally is due to dollar weakness. The Pound remains vulnerable to slower GDP, CPI and political/Brexit uncertainty.

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

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

	USD	EUR	GBP
Govies	**Sell the 30y UST in ASW** Entry level = 18bp. Target level = 30bp. Stop loss = 12bp	**1) Buy SPGB 2.35 Jul'33; sell Bund 4.75 Jul'34** at 86bp.Target =70bp. **2) BTP-SPGB 2025-20234 box trade** at -2bp. Target -12bp.	**Gilt 30s/46s ASW box steepener** Entry level = 20.8bp. Target level = 25bp. Stop loss = 17bp.
Rates	**1) Pay the belly in 2s5s10s** Entry = 3bp. Target = 10bp. SL= 0bp **2) Receive 15y vs. pay 5y5y** Entry sprd level = 7bp.Target = 30bp. Stop loss = -5bp **3) Pay 2y2y in USD swaps** Entry level = 2.90%.Target = 3.30%. Stop loss = 2.70%	**1) Receive 5f5y IRS / pay 10f5y IRS** Now 44bp. Target = 50bp **2) Pay USD 8y / Receiver EUR 8y** At 194bp. Target = 210bp	**1) GBP 1s5s OIS steepener**. Entry level = 40bp. Target level = 50bp. Stop loss = 36bp. **2) Buy 20y gilt inflation break-even (outright or vs. 10y).** Entry level = 343bp. Target level = 350bp. Stop loss = 335bp.
FX	**Buy USD/JPY** at 107.00 target= 114, with a stop loss at 104.00	**Sell EUR/NOK** original entry at 9.80, sell now 9.60. Target = 9.30. SL = 10.05.	**Sell GBP/USD** original entry at 1.3960, sell now 1.4050, target= 1.3600, with a stop loss at 1.4200

Global Strategy: Reasonable doubts, but no fundamental changes

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

Despite the healthy macro environment, the feeling that upward growth revisions might be already behind us, geopolitical and name-specific uncertainties and the aim of protecting the very nice returns provided by risky assets in recent years have all increased investors' concerns, taking some chips off their risky asset allocations.

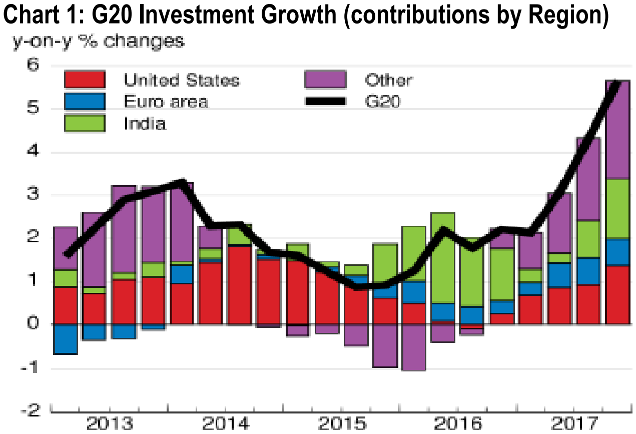
This moderate sentiment shift has benefited global rates or, in the case of USTs, kept them from rising further. We are not negative risky assets and expect 10y USTs to break the 3% level later this year. But, tactically, we think this move can continue in coming weeks.

Broad and solid recovery, but…

The global macro outlook remains solid, as depicted by the OECD in its recent Interim Economic Outlook. Interestingly, they see stronger investment and better employment dynamics, helping to make the ongoing recovery increasingly broad-based, with solid job creation. Furthermore, the OECD also seems optimistic about the near future, expecting the world economy to strengthen further over the next two years, with global GDP growth projected to reach almost 4% in both 2018 and 2019 (see Table 1), and with notable upgrades in its US growth forecasts (+0.4% and +0.7% respectively).

That said, the new numbers for the US growth ahead are slightly above our expectations but, more importantly, we share some of the OECD's concerns regarding the macro and financial outlook for the coming quarters. We are closely watching several important growing tensions, such as the high debt levels in many countries or the potential risk involved in the upcoming monetary policy normalisation, in a context of still-elevated risk-taking and financial vulnerabilities.

Chart 1: G20 Investment Growth (contributions by Region)



Source: OECD

Table 1: OECD Real GDP Forecasts; growth (yoy)

	2017	2018		2019	
		Interim EO projections	Difference from November EO	Interim EO projections	Difference from November EO
World[1]	3.7	3.9	0.2	3.9	0.3
G20[1,2]	3.8	4.1	0.2	4.0	0.2
Australia	2.3	3.0	0.2	3.0	0.3
Canada	3.0	2.2	0.1	2.0	0.1
Euro area	2.5	2.3	0.2	2.1	0.2
Germany	2.5	2.4	0.1	2.2	0.3
France	2.0	2.2	0.4	1.9	0.2
Italy	1.5	1.5	0.0	1.3	0.0
Japan	1.7	1.5	0.3	1.1	0.1
Korea	3.1	3.0	0.0	3.0	0.0
Mexico	2.3	2.5	0.3	2.8	0.5
Turkey	6.9	5.3	0.4	5.1	0.4
United Kingdom	1.7	1.3	0.1	1.1	0.0
United States	2.3	2.9	0.4	2.8	0.7

Source: OECD

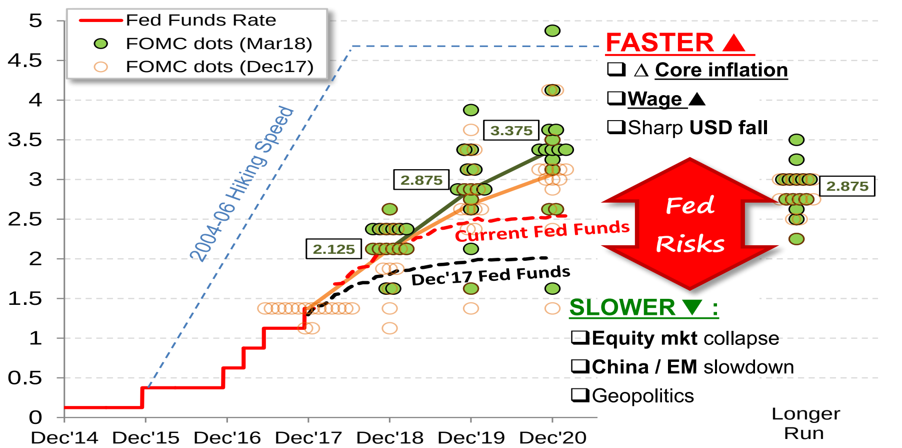
Coming back to macro fundamentals, a similar macro environment was depicted in the updated macroeconomic projections in the recent meetings of the two most relevant Central banks

A more optimistic Federal Reserve

In its latest round of macro projections, the **US Federal Reserve** also clearly raised its growth forecasts for both 2018 (+0.2% to 2.7%) and 2019 (+0.3% to 2.4%), maintaining its expectation of a deceleration towards 2% in 2020. It would seem that a large amount of this upward revision could be related to cyclical –rather than structural– factors, given the latest US tax reform, as Fed members kept their longer-run growth projection at a much more modest 1.8%. Against this backdrop, and as universally expected, **the Fed last month raised its official rate corridor by 25bp** (to 1.5-1.75%), but the shift in the number of members expecting a total of four hikes this year was not enough to change the median dot for December 2018, which –just– remains at three hikes in total for this year.

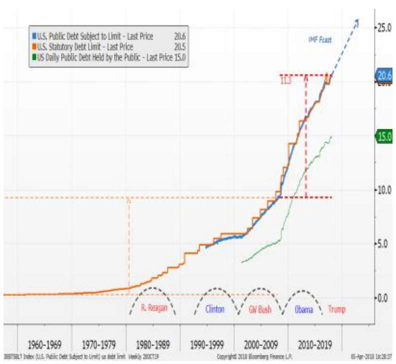
But the margin is now so small it could change with the arrival of the new Fed members (Chart 2). Furthermore, the median of the FOMC expectations shifted to three (rather than two) hikes for 2019 (+20bp compared to the Dec-17 FOMC) and with a much larger 50bp change in the 2019 median Fed Fund 'dot' (to 3.4%, from 3.1%). In this regard, we agree with the new Fed Chair about the market's "obsession" with the median dots and not only because of their purely statistical nature, but also given the massive discrepancy between the different Fed members: while one of them expects rates to stay at the current levels to the end of 2019, another sees official rates between 3.75%-4.0% by the end of next year.

Chart 2: Fed Fund Rates, FOMC projections (dots) and Fed Funds



Source: Bloomberg, Santander

Chart 3: US (Gross and Net) Public Debt (USD, trn)



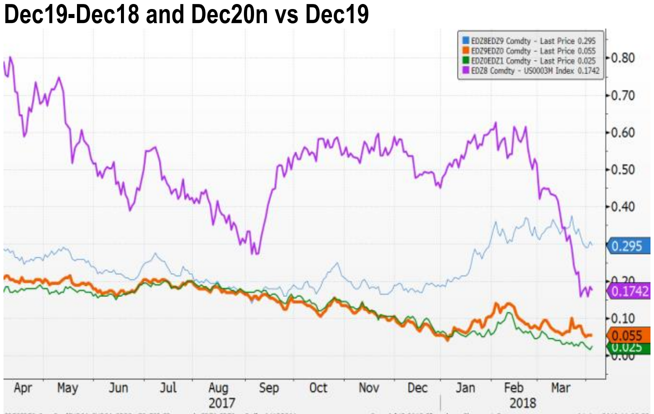
Source: Bloomberg, Santander

Justified optimism ... or potentially reckless behaviour?

Once again, market participants disagree with the Fed about what its members will actually end up doing. Because they think the macro and financial situation will not be solid enough to justify such tightening and/or they believe (as we do) any structural inflationary threat is not large enough to justify such an asymmetrical risk move, particularly given the huge amount of public debt that will need financing at increasingly higher rates (Chart 3).

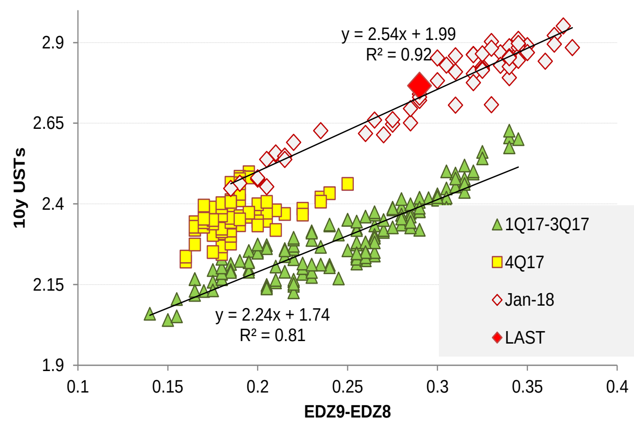
In fact, despite the above-mentioned official projections, the Dec18-Dec19 ED spread trades at 31bp, with the EDZ0-Z9 at just 6bp (Chart 4). An interesting opportunity if the Fed decides to distribute more evenly its expected hikes more evenly over the next two years. As also seen in Chart 5, the long end of the US curve seems to be very closely correlated with these rate hike expectations and, should the Fed finally hike by what its Dec'19 median dots suggest (to 2.875% from 2.125% in Dec'18), the risk would be for 10y Treasuries to rise towards the 3.5% level, with potentially dangerous repercussion for global financial markets.

Chart 4: Eurodollar spreads; Dec18 vs US3m spot, Dec19-Dec18 and Dec20n vs Dec19



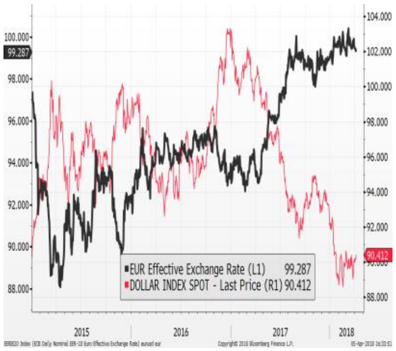
Source: Bloomberg, Santander

Chart 5: US 10y rates regressed vs EDZ9EDZ8



Source: Bloomberg, Santander

Chart 6: Trade weighted EUR and USD exchange rates



Source: Bloomberg, Santander

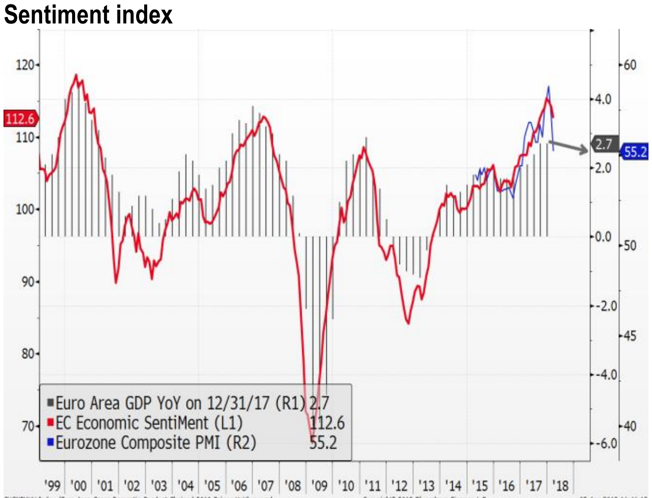
Despite its *statistical nature*, we also find it interesting that, while the FOMC median projection for the end of 2019 is the same than in the 'longer run' (2.9% Fed Funds), it is lower than the number for the end of 2020. In other words, many members forecast going beyond normalization (i.e., an actual monetary tightening) in Fed Funds two years from now. This is something that we believe, at this stage, seems an unnecessary risk, as we have argued in the past about the potentially destabilizing aspect of a large increase in US long-term rates in both advanced and emerging financial markets.

ECB another –tiny– step towards normalization

On this side of the Atlantic, probably biased by the divergent currency performance (margin chart), the ECB was much more modest than the Fed in its revisions. In its [recent round of macro projections](), based on a better contribution from GFCF and exports, the Euro zone monetary authority only raised its growth forecast for 2018 (and by just one-tenth to 1.9%), but left its 2019 and 2020 projections unchanged.

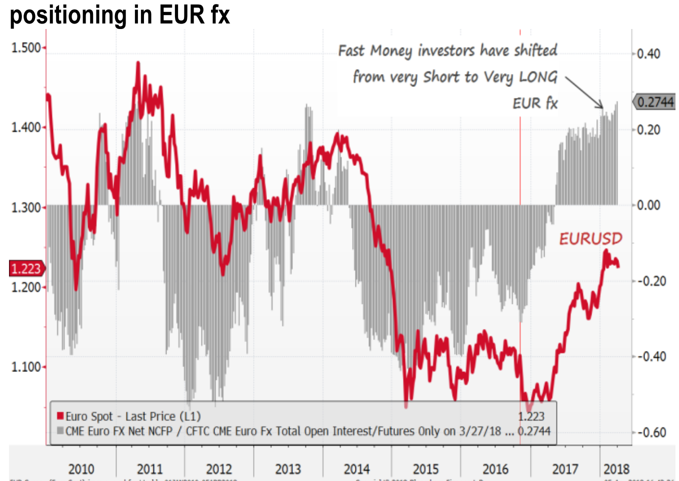
Monetary policy-wise, the meeting was not a big event either. But, thanks to Draghi's relatively dovish tone, the ECB was able to remove a closely-watched part of its statement ("*the ECB stands ready to increase the APP in terms of size and/or duration*") and yet keep markets, especially the EUR, basically unchanged, with only peripheral bonds clearly benefiting.

Chart 7: Euro Area GDP (yoy) vs Composite PMI and Economic Sentiment index



Source: Bloomberg, Santander

Chart 8: EURUSD Exchange Rate vs Fast Money accounts positioning in EUR fx



Source: Bloomberg, Santander

As highlighted last month ([FX Dynamics & Implications for Financial Markets - Interest & Exchange]()), with the FX market more focused on (actual and expected) growth differentials rather than interest rate spreads, this news, plus the recent decline –albeit from very high levels– in several Euro area business surveys (Chart 5) and some weaker–than-expected real economy economic indicators have helped the EUR move away from the $1.25 level it has attempted to break through each month this year. As highlighted in the past (see also [FX section]()), and with the market very long the EUR (Chart 8), we believe the Single Currency can remain around this $1.22 area before attempting –and finally managing– to break through the $1.25 mark in the second half of the year.

We continue to expect the ECB to continue buying bonds (€30bn/mth) **until September 2018, probably followed by a small tapering in 4Q18** (€30bn in total)**, with the first rate hike likely coming around mid-2019.**

However, we would assign a 25-30% probability of these purchases ending in September 2018, thus allowing for hikes from March 2019. But this should only be the case if the economy manages to sustain its current growth pace, rather than decelerate as the market (and the ECB) expects. We would also keep an eye on wage settlements and any sizeable fiscal easing, given the new political environment in several European countries. And of course, in the Euro zone, as a strong euro could delay the process and vice versa

Substantial uncertainties weighing on global markets

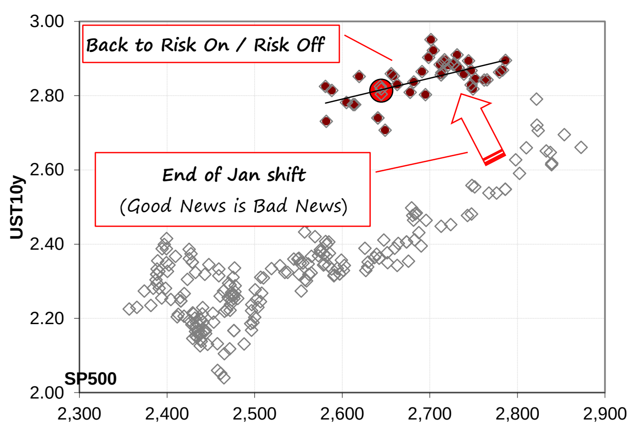
We believe the above-mentioned uncertainties highlighted by the OECD, together with the expensive valuations of many assets, are two of the main drivers behind the recent risk-off move, that has caused a relatively moderate retracement in risky assets, but a marked increase in investor jitters. We would also add the recent negative news flow in some of the big corporate names that have led equity markets higher for the last couple of years. All these factors have also benefited high-quality global rates.

Interestingly, the recent move has been different from the *'good news, bad news'* days at the end of January this year, when strong economic data caused concerns about sizeable hikes in official rates becoming a potential *monetary policy mistake.* Back then investors sold both 'risky' and 'risk-free' assets (equity prices down / yields up, see Chart 9). Yet, in the last few weeks, the correlation between US Treasury and equity prices has been negative (risk on / risk off), with US rates benefiting in risk-aversion moments. This is especially important after the whopping 50bp sell-off in 10y USTs in January. But the chart also shows that this sharp increase in rates is unlikely to unwind, as suggested by the new stable relationship between both assets.

We remain cautious on US rates in the medium run, expecting the 3% level to eventually be broken in 10-year rates, but, for the time being, **we would not use this moderate rally to load into shorts at current levels.** Further risk-off (profit-taking) moves cannot be ruled out due to a combination of slightly worse macro sentiment (or at least negative second derivatives), the potential macro and financial implications of a deterioration in the trade conflict between the world's two largest economies, together with some profit taking as, at the end of the day, the global equity market cap is still 35% above pre-US election levels (+$23trn). This sentiment could lead to a further unwinding of US rate shorts by fast money accounts as, despite the $20bn decline in 10y equivalents short positions in US rates via futures (Chart 10), these shorts are still close to their all-time highs, especially in the ED curve and the 5y-10y area.

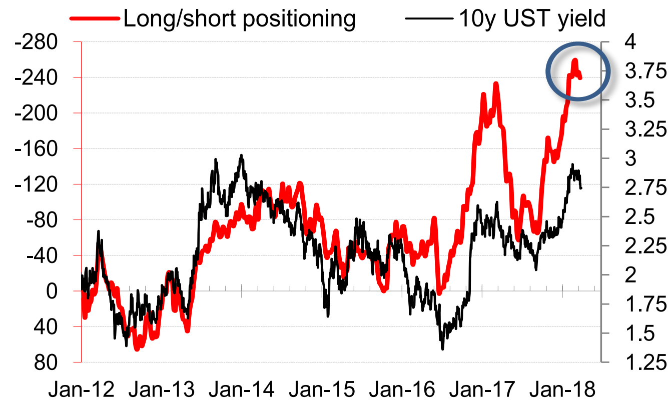
Additionally, at 2.63%, five-year US Treasuries appear very attractive compared not only to -8bp in German OBLS, but also the respective 17bp and 66bp similar-maturity Spanish and Italian government govie bond yields.

Chart 9:UST10y vs S&P500 – shifting correlations



Source: Bloomberg, Santander

Chart 10: Net Long (+)/ Shorts(-) in USTs (10y equivs) vs. 10y yield (RHS)



Source: Bloomberg, Santander

Turning to EUR rates, in previous editions we explained that, given the different demand/supply dynamics, and despite much lower absolute yields, European rates were replicating the moves in US rates with a very high beta (88% between 10y Bunds and USTs in January 2018). This has partially reversed, with Euro rates clearly outperforming their US counterparts, lowering the year-to-date betas to c.40%. We believe this situation should continue (40%-50%-ish betas), with this elasticity increasing in the second half of the year, as the end of the ECB's purchases get closer.

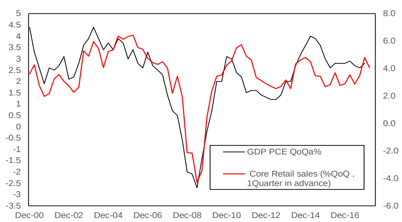
US Economic Outlook

Antonio Espasa
(+34) 91 289 3313

Beatriz Tejero
(+34) 91 257 2176

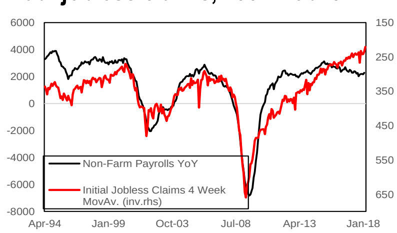
The Federal Reserve raised its forecasts and views on the future performance of the US economy in its last FOMC meeting. However, it acknowledged that the economic performance could be weaker in the short run. The 1Q18 hard economic data already published have been weaker than in 4Q17 and could point to lower GDP growth rates quarter-on-quarter. However, although the 1Q18 numbers might not be as good as expected, we believe that leading business confidence indicators clearly signal much stronger growth rates during the rest of the year. So, we maintain our positive GDP forecasts for 2018-19E.

Chart 11: US – Core retail sales vs GDP PCE %YoY, 2000-1Q18



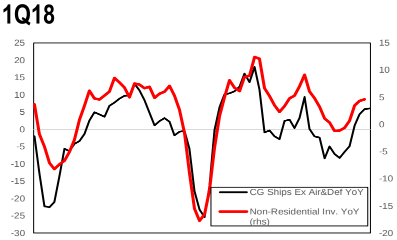
Source: US Census Bureau, BEA and Santander.

Chart 12: US – Non-farm payrolls vs initial jobless claims, 1994-Feb18



Source: DoL, BLS and Santander.

Chart 13: US – Durable goods orders vs GDP non-resid. investments, 2001-1Q18



Source: US Census Bureau, BEA, Santander.

FOMC changes economic forecasts: Average GDP for 2018 and 2019 revised to 2.7%YoY and 2.4% (vs 2.5% and 2.1% in December)

In his first FOMC as Federal Reserve Chairman, Jerome Powell signalled that economic activity remains strong with a very sound labour market, although it seems that Consumption and Investment have moderated slightly in recent months vs the 4Q17 readings. In fact, the Federal Reserve Board members' revisions to their GDP, unemployment and inflation estimates for 2018, 2019 and 2020indicate that the US economy is likely to remain robust in the coming quarters.

The GDP estimates were revised up for 2018 and 2019 to levels beyond the 1.8% YoY set as the long-term trend because of the foreseeable impact of the fiscal stimulus on investment. Our GDP forecasts are 2.5% for 2018E and 2.6% for 2019E, so we also expect significant acceleration after the 2.25% YoY growth posted in 2017. However, some short-term numbers could be relatively weak.

Personal consumption weakness in 1Q18 vs 4Q17 should be short-lived

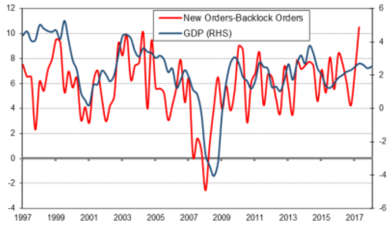
Retail sales have retreated considerably so far in 1Q18. Acknowledging that we only have the numbers for January and February, we observe a cumulative -0.2% QoQ in 1Q18 vs the 1.4% QoQ in 4Q17 QoQ and 2.4% QoQ in 3Q17. This could lead to PCE growth rates of 2.5% YoY in 1Q18E vs the 2.8% YoY reported in 4Q17 and 2.6% YoY in 3Q17. However, job creation remains very strong, with the four-week moving average of the initial jobless rates pointing to an annual non-farm payrolls growth rate above 3.0% vs the current 1.6%. This, together with the fact that average hourly earnings remain in the 2.3%-2.8% YoY range (since the beginning of 2016), indicates that workers' income should remain stable. Therefore, PCE growth rates should be sustained with low risks of inflationary pressures.

Investments have softened in 1Q18, but are likely to rise in the near term

Durable goods orders were significantly weaker than expected in January (-3.7% MoM vs -2.0% MoM expected) and than the 1.3% MoM average recorded in 4Q17. Shipments of core capital goods (capital goods excluding defence and civilian aircraft) tend to be a good indicator of GDP-non-residential GFCF. So far, shipments of core capital goods signal a deceleration in non-residential investments, at almost -10% QoQ vs the 6.6% QoQ reported in 4Q17 (although we only have the final core capital goods shipment numbers for January and the first reading for February). Note that the Eurozone is the destination of 20% of US exports, and since we expect stronger Euro zone GDP growth in 2018E (2.4%), this should also foster stronger CAPEX growth rates in the US; especially since capacity utilisation has risen to 78.1%, the highest level since the beginning of 2015. We believe that the lack of investment in CAPEX might be limiting production and this is eroding productivity (0.0% QoQa in 4Q17).

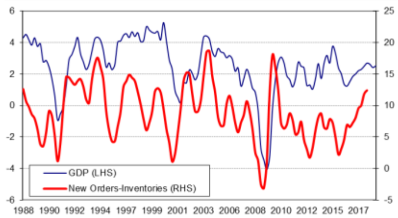
Regarding residential investments (20% of total US private investments), existing home sales have dropped by -0.23% QoQ so far in 1Q18 vs 3.62% QoQ in 4Q17. However, the strength of the labour market, together with the accommodative financial conditions, should support future demand in the sector, although prices (12-month average at historical highs) could limit additional growth.

Chart 14: US – GDP vs ISM Services new orders-backlog orders, 1997-Feb18



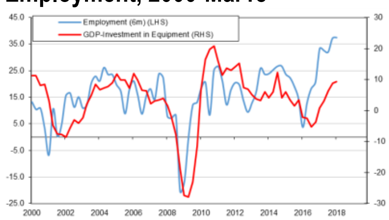
Source: BLS and Santander.

Chart 15: US – GDP vs ISM Manufacturing new orders-inventories, 1988-Feb18



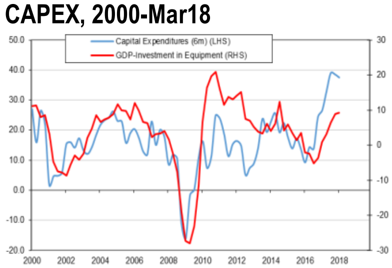
Source: BLS and Santander.

Chart 16: US – GDP investment equipment vs Philadelphia Fed Employment, 2000-Mar18



Source: Datastream and Santander.

Chart 17: US – GDP investment equipment vs Philadelphia Fed CAPEX, 2000-Mar18



Source: Datastream and Santander.

Leading business and consumer confidence indicators imply stronger GDP growth rates in coming quarters

While the hard 1Q18 economic data already released point to smaller GDP growth rates in the quarter, as previously commented, leading confidence indicators clearly imply a different scenario for the rest of the year. Indeed, they are actually anticipating an acceleration in GDP growth in coming quarters.

The headline indices of those indicators have recently been moving upwards, while their breakdowns clearly highlight the existence of some important imbalances between supply and demand in the economy. That is, the recent acceleration in final demand questions the capacity of the current levels of installed capacity to satisfy that acceleration in demand. This imbalance is evident in the different performances of some components of those business confidence indicators like: new orders, inventories, employment, production and backlog orders.

Although it is true that headline business confidence indices have risen in recent months –the services ISM to 62.8 in February from 59.8 in January and 57.8 in December; the manufacturing ISM to 62.8 in February, the highest level since the 63.8 reached in April 2011– the relationship between the different components of those indices probably tells us more about the future performance of the economy than the headline itself.

New orders, inventories, backlog orders, production and employment all point in the same direction…

The ISM indices are showing very strong increases in new orders, with the manufacturing index at 64.2 and the services one at 64.8 in February. The logical acceleration in production or activity in both sectors has not been able to satisfy that sharp increase in new orders yet. As a result, we are seeing how backlog orders are growing faster than in the past and inventories are being reduced at a quicker pace. This is the obvious result of companies being unable to produce as fast as demand is growing due to their lack of production resources, or installed capacity. So, as also shown in the charts, in the surveys companies express their intentions of increasing those capacity levels in the future. That is, the Philadelphia Fed Index components like intentions of raising capital expenditures in the next six months, or the one on future (next six months) employment creation, are moving upwards quite fast, reflecting that need to boost production capacity.

The final result of this imbalance, anticipated by the relative performance of leading business confidence indicators, tends to be an acceleration in GDP growth rates in the following quarters.

…and employment, production –and investments in the future– are already reacting positively to those moves

Payrolls survey numbers showed strong (313k) employment creation in February. The private sector generated most of those jobs (287k), with the goods-producing sector accounting for 100k and the service-providing sector being responsible for 187k. Both construction (61k) and manufacturing (31k) generated jobs in the goods-producing sector. Industrial activity is also accelerating. Manufacturing production grew by 1.6% QoQ in 4Q17 and is up by 0.5% QoQ so far in 1Q18. We expect further positive news on both statistics and investments in coming quarters. Indeed, the recent trend in investment indicators has clearly improved.

US Rates Strategy: Time to reload carry-efficient shorts

José María Fernández
(+34) 91 257 2244

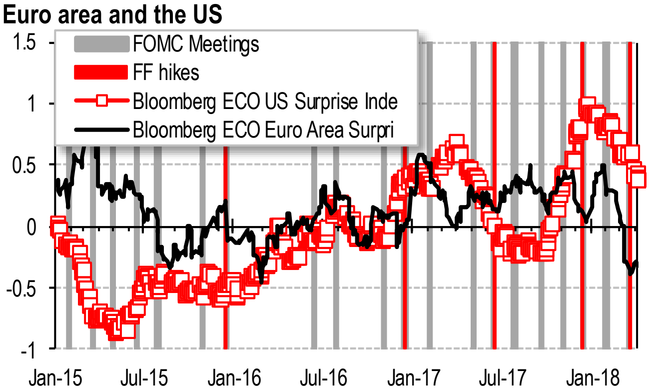
- **The recent downward correction in US rates fits perfectly with the scenario we were expecting. At these levels, we are taking profits in our tactical positioning aimed to capture the outperformance of the belly vs. the front and the long end of the US curve.**
- **We continue to think that the medium-term trend is for higher US rates and that we will revisit (and probably break) the 3% mark in the 10y during 2H18. But, in the short run, the bearish momentum is losing steam and we see a limited risk of an imminent sell-off in US rates. Therefore, we now prefer to focus on carry-efficient alternatives to go short. In particular, we like paying the belly in the 2s5s10s fly.**
- **Front-end rates, on the contrary, still seem to be underestimating the number of hikes suggested by the Fed. We believe the room for repricing is ample and clearly higher than the adverse negative roll-down of being short in the forward space, so we maintain our call to pay the 2y2y USD swap rate as a medium-term, strategical positioning.**

The recent rally has brought dislocations to an end

Market sentiment has changed significantly in the last couple of weeks. With US equities under pressure (mostly due to corrections in the big techs) and an increasing focus on the possible impact of trade tariffs, US rates in the belly and the long end have rapidly returned to (the belly), or even broken through (the long end of the curve), the lower end of the ranges seen since February.

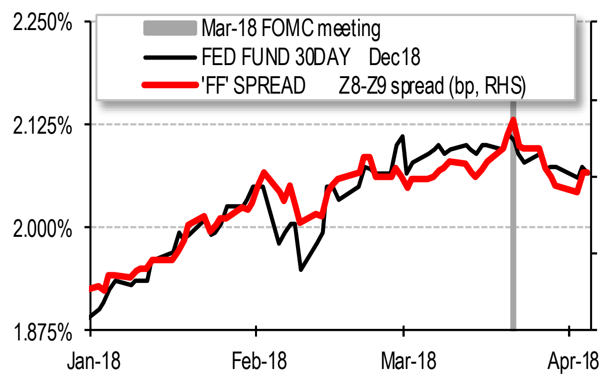
This, combined with a gradually declining number of positives surprises on the macro side (Bloomberg surprise indices in the US are still far from turning negative, like in the Eurozone, but are certainly less impressive than at the beginning of the year – see Chart 18), is making a dent in monetary policy expectations in the US. And the market is now pricing in a smaller number of FF hikes for both this year and next than before the FOMC meeting (see Chart 19), even with the latest dot plot suggesting a slightly more hawkish Fed. With EUR rates still showing no sign of a pause in the downward trend that started in mid-February and **unlike on previous occasions when US rates have reached these levels, a rebound back to the higher end of recent ranges now looks a bit less probable**.

Chart 18: Economic surprises over the past two years in the Euro area and the US



Source: Bloomberg, Santander.

Chart 19: Market expectations* for official rates in the US – FF rate as at Dec'18 *(%)* **and cumulative hikes during 2018** *(bp)*

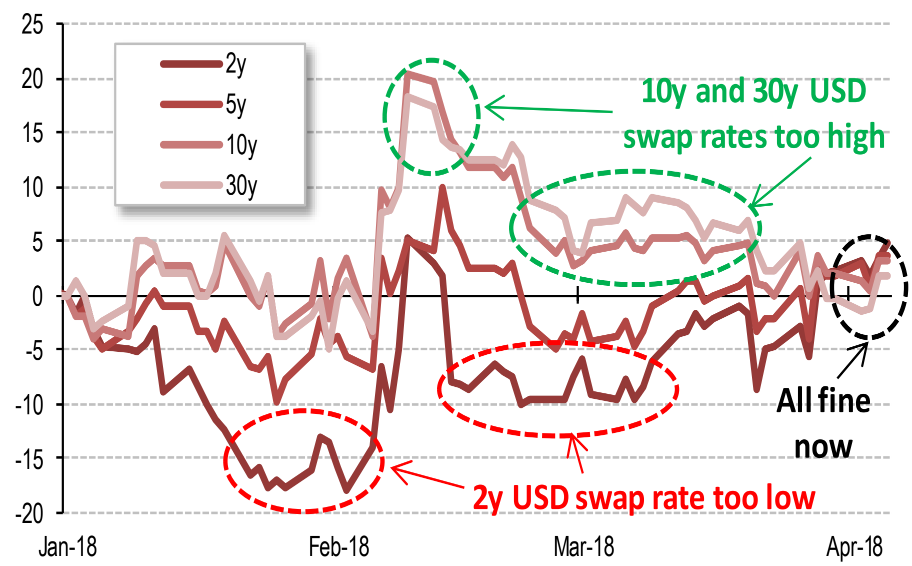


* As priced in FF futures. Source: Federal Reserve, Santander.

Focusing on strategic views again

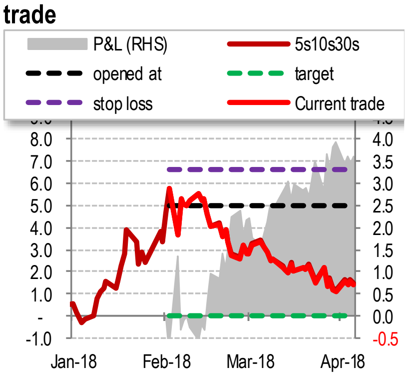
This is indeed **the kind of scenario we have been projecting in our forecasts for the past couple of months**, when we argued that the belly and long end of US curves looked too high. So, we temporarily suspended our strategical shorts to enter into tactical longs in the belly vs. the wings, **looking for a correction in the dislocations generated by January's sell-off**. These distortions seem to have corrected now (see Chart 20) and, therefore, **we are shifting our positioning back towards our strategical call of looking for carry-efficient alternatives to go short** (as proposed in our Year-Ahead report, back in December) in those tenors.

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



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

Chart 21: Receive the belly in 5s10s30s – mark-to-market of our trade



Source: Bloomberg, Santander.

Therefore, **we now see limited gains in receiving the belly in the 5s10s30s fly and have decided to close it now**, even if it has not fully reached our target.

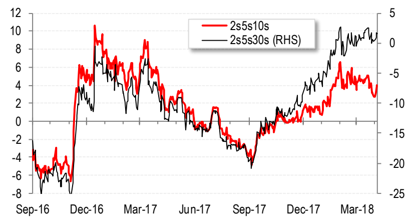
Closing Trade: Receive the belly in 5s10s30s spot
Entry level = 5bp. Target level = 0bp.
Closing at 1bp

We opened this trade on 2 February, when the spread was at 5bp, targeting a return to the 0bp area (consistent with the market correcting the dislocations identified in Chart 20 at that date). We are closing it with profits (see Chart 21) now that we are approaching our target and our model suggests that additional gains could be limited.

Back in March we also recommended receiving the 15y and paying the 5y5y, which has not performed as well as expected (we opened it at a spread of 7bp, targeting a widening to the 30bp area, but it has tightened by around 4bp since then). We are still far from our stop loss (set at -5bp) and, for the time being, still think this trade could perform well as **our model continues to suggest that the 15y is too high compared to its historical correlation with the 5y5y**. Therefore, we feel comfortable keeping this trade open, despite the current negative mark-to-market.

1) Carry-efficient alternatives to go short the belly

Chart 22: 2s5s10s vs. 2s5s30s in USD swaps



Source: Bloomberg, Santander.

We continue to think that the medium-term trend is for higher US rates and that we will revisit (and probably break through) the 3% mark in the 10y during the second half of the year. **But, in the short run, the bearish momentum is losing steam** and we think that it would take inflation figures suggesting some underlying pressure building up (which does not look like an immediate threat right now) for the risk of a sell-off in US rates to materialise. Therefore, we think that **holding outright shorts in the belly and the long end could be painful – not so much because of fears of an adverse mark-to-market, but because of the punitive negative carry.**

In that connection, **we particularly like paying the belly in the 2s5s10s fly**. As discussed in our Year-Ahead report, we believe this fly should capture both the possible hawkish repricing in monetary policy expectations (which we expect to push the 2y2y higher, as mentioned earlier, and also to make 2s5s steepen), as well as some possible flattening in 5s10s.

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

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

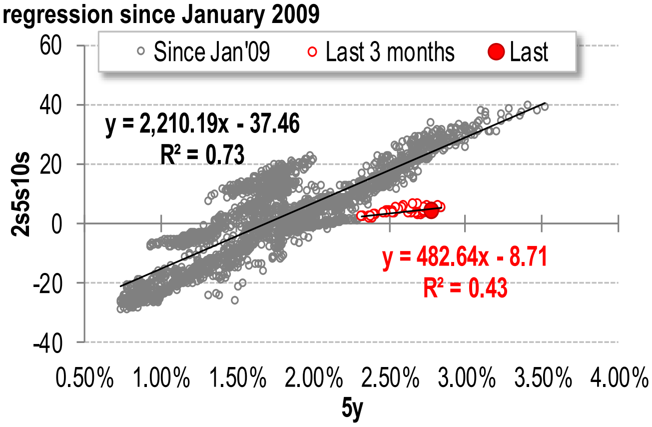
Source: Bloomberg, Santander.

As shown in Charts 22 and 24, **several metrics indicate that the fly spread is low, compared to historical correlations**. And Chart 23 provides evidence of a strong correlation with changes in absolute levels in the 5y swap, so that the trade should perform well once US rates resume their upward trend. Additionally, **the 3m carry is marginally positive** (2.3bp negative in the case of paying the 5y) **and the 3m roll-down is quite supportive** (1.3bp). Accordingly, the total carry and roll-down of the position is around 4bp (not beta weighted) better than just paying the 5y. That should provide some extra protection in case the market moves slightly against us or if, as we fear, it takes some time until the sell-off in US rates resumes.

Trade idea: Pay the belly in 2s5s10s spot
Entry level = 4bp. Target level = 10bp. Stop loss = 0bp
3m carry = +0.2bp. 3m roll-down = +1.3bp

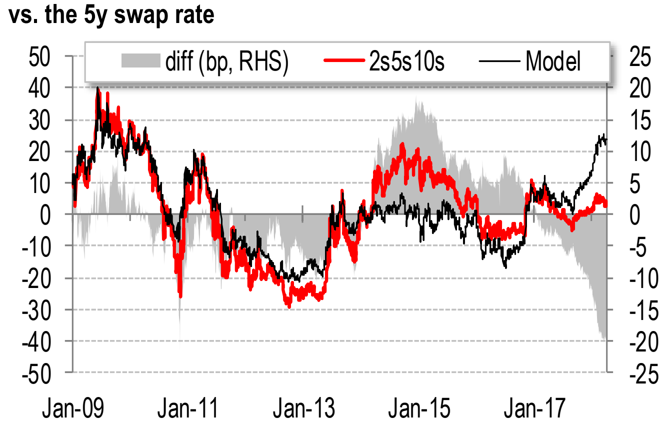
This is a trade we suggested in our Year-Ahead report published in December (at 1bp) and that we decided to close in February, when our target (5bp) was reached and the dislocations generated by January's sell-off suggested that some retracement was possible. Now that those dislocations have been corrected, we enter it again, setting our new initial target at 10bp (a level that would be consistent with the current market values of the 2s5s30s fly or the 5y swaps reaching our year-end forecasts, if long-term correlations resume).

Chart 23: 2s5s10s fly vs. 5y spot in USD swap rates – Linear regression since January 2009



Source: Bloomberg, Santander.

Chart 24: 2s5s10s fly model based on the historical correlation vs. the 5y swap rate

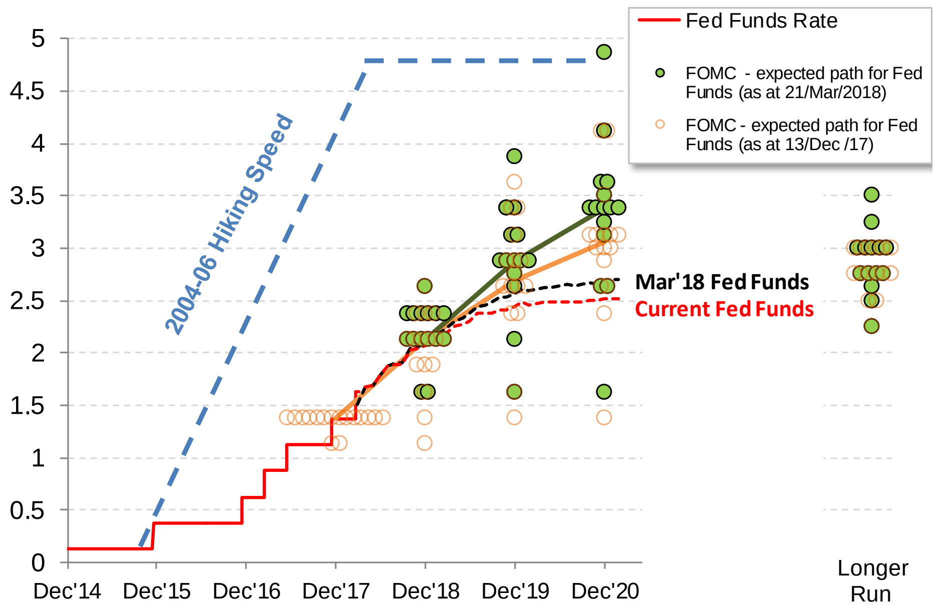


Source: Bloomberg, Santander.

2) Front-end rates should continue to inch higher as the Fed revises the dot plot higher

Front-end rates, on the contrary, still seem to be underestimating the number of hikes suggested by the Fed. The combination of upward revisions in the Fed's dot plot in the March 2018 Summary of Economic Projections (SEP) and the recent downward correction in monetary policy expectations priced in by the market translates into an additional widening in that gap (see Chart 25).

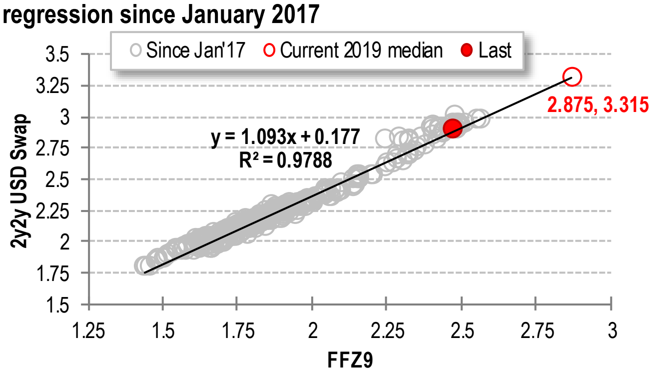
Chart 25: December 2017 FOMC dot chart vs. FF futures



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

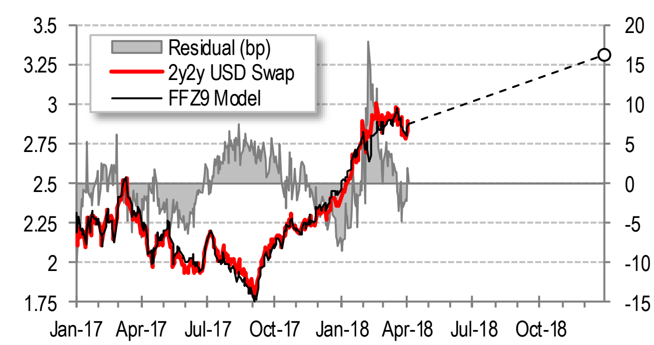
And, as discussed in detail in the FOMC post-mortem included in our 22 March MMD, **we believe the room for repricing is ample and clearly higher than the adverse negative roll-down of being short in the forward space**. So, **we maintain our call to pay the 2y2y USD swap rate as a medium-term, strategical positioning** – as we think it could end the year at around the 3.30% level if the FF rates follow the path depicted in the latest FOMC dot plot (see Charts 25 and 26).

Chart 26: 2y2y USD swap rate vs. FFZ9 future – Linear regression since January 2017



Source: Bloomberg, Santander.

Chart 27: 2y2y USD model based on the historical correlation vs. the FFZ9 future



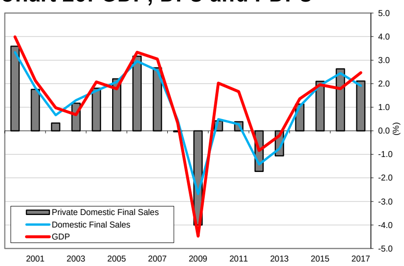
Source: Bloomberg, Santander.

Euro zone Economic Outlook

Laura Velasco
(+34) 91 175 2289

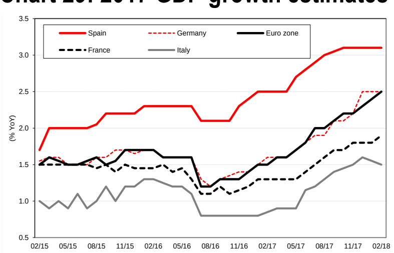
Euro zone GDP growth beat expectations, supported by the improvement in fundamentals for domestic demand and the surge in exports. We have updated our growth forecasts accordingly and continue thinking it can also deliver very good results in 2018E and 2019E, putting special attention on the performance of investment, salaries and core inflation.

Chart 28: GDP, DFS and PDFS



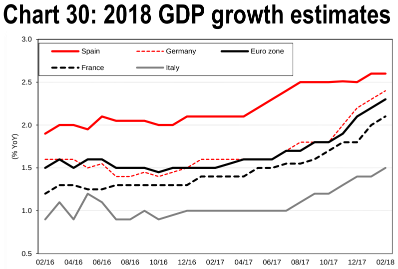
Source: Eurostat and Santander.

Chart 29: 2017 GDP growth estimates



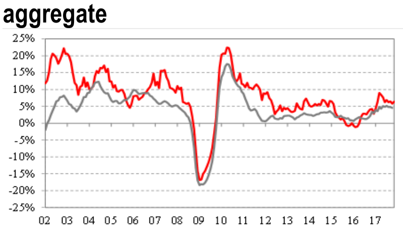
Source: Eurostat and Santander.

Chart 30: 2018 GDP growth estimates



Source: Eurostat and Santander.

Chart 31: World trade & SAN ports aggregate



Source: Datastream and Santander Proprietary Trade Flows Index.

Euro zone GDP: are forecasts made to be beaten?

The Euro zone economy expanded by 2.5% in 2017, its highest since 2007, and, as we documented in detail in our report Economics: Euro Zone: GDP Growth Should Consolidate above 2.0%, it can also deliver very good results in 2018E and 2019E, even beaten consensus estimates again. In our view, the significant and generalised improvement of fundamentals in the largest Euro zone economies should provide plenty of support to GDP growth in the area. Moreover, the smaller economies have also experienced significant improvements. 2017 GDP growth ended up even stronger than we were expecting (2.3%), due to a very good performance of the economy at the end of last year and upward revisions to quarterly data already released.

Importantly, growth in 2017 was more balanced in terms of composition. While in 2015 and 2016 growth was mostly explained by internal demand, the 2017 breakdown changed, with not just internal demand pushing GDP upwards but also net exports. GDP grew 2.0% in 2015 with domestic final sales (DFS) up 1.9%, while the 2016 rate came in at 1.8% versus the DFS advance of 2.4%. Last year, however, GDP grew 2.5%, with DFS up 1.9% and net exports having a positive contribution of 0.6pp.

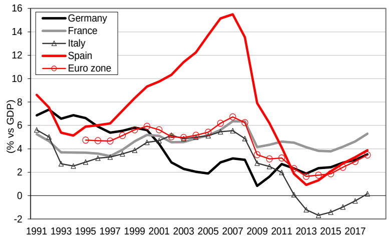
We expect internal demand to give a very positive performance, with DFS growing 2.2% in 2018E and 2.4% in 2019E. Private domestic final sales (PDFS) growth should accelerate in 2018E (to 2.4%) and 2019E (2.7%), supported by stronger fundamentals in the private sector. Furthermore, after the poor performance of world trade in 2016, 2017 saw a 4.5% increase, and we believe that global growth rates are likely to accelerate even more in 1H18 and then stabilise during the rest of the year. In other words, we consider that the recovery of world trade, the strength of world GDP and the very good competitive position of the Euro zone are going to support the area's exports. The only risk we see is the possible implementation of restrictions to free trade by various countries after the decisions being taken by the Trump administration on import taxes for steel and aluminium.

Investment should keep growing

As already mentioned, activity has been accelerating in the Euro zone since 2013 but, that said, net fixed capital formation (NFCF) remains close to historical lows. In our opinion, capex is likely to be the next step taken by companies, that should help to extend the current growth cycle by two to three more years in the Euro zone.

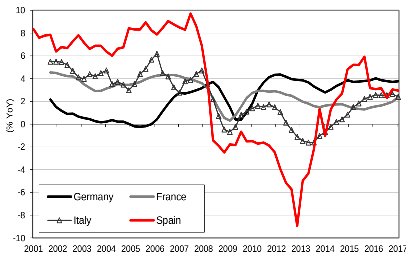
On the one hand, investment in construction has been declining as a percentage of GDP since 2007, although at uneven pace when broken down by individual country. Investment in construction is not likely to return to the levels reached at the last peaks in each country, but has scope to improve from current levels. On the other hand, investment in equipment as a percentage of GDP has been recovering since 2009, although at very different speeds in each country and being more dependent on exports than on domestic economic activity. For example, in Spain, we see that the marked recovery of investment in equipment vs GDP responds to the structural change that has transformed the economy and fostered exports. In the other three major economies, there is scope to increase investment in equipment/GDP, especially if export dynamics remain strong.

Chart 32: NFCF (% GDP)



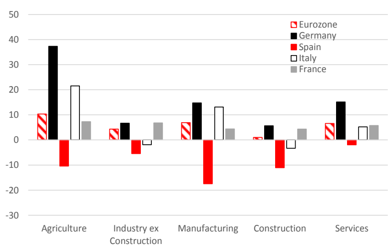
Source: Eurostat and Santander.

Chart 33: Households, aggregate wages and salaries



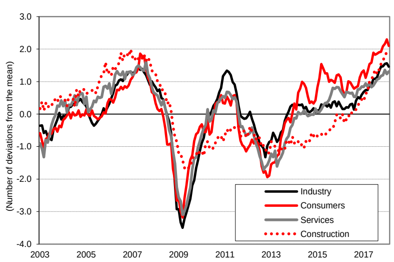
Source: Eurostat and Santander.

Chart 34: Nominal unit wage costs, accumulated vs 2010



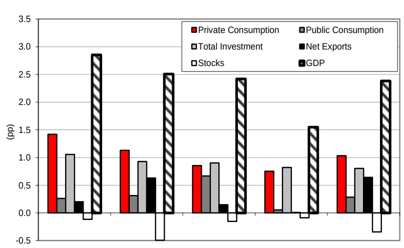
Source: Eurostat and Santander.

Chart 35: Confidence



Source: EC and Santander.

Chart 36: GDP breakdown for 2018E



Source: Santander estimates.

Salaries, employment and hours worked. Where are we after the crisis?

Since 2009, wages and salaries (the number of people working times the salary per worker) have been recovering in the Euro zone, although at different paces and at different times in each country and sector. However, since 2016, they have been growing across all four major economies at the same time and almost at the same pace, mainly thanks to employment generation. This is one of the factors that has fostered the resilience of the Euro zone's recovery and the strength of the cycle.

However, in some cases, companies are reporting a lack of an adequate workforce as a constraint to increasing production. Furthermore, in recent months, business surveys show that, as a consequence of this constraint on labour, salaries per employee are picking up, which is one of the reasons why input costs are rising.

All in all, we draw the conclusion that, regarding employment and salaries, the situation varies markedly by country and sector. However, taking Germany (which leads the expansionary cycle) as an example of what might occur in the other Euro zone countries, we believe that two to three years might elapse before wages and salaries start being a problem for corporate margins, and, even then, increases in capex and the positive impact on productivity could be moderating factors.

That said, we highlight that Germany urgently needs to invest in capex to offset the loss of its workforce's competitiveness and the increase in working hours to maintain production and productivity. The rise in salaries, together with the tight workforce situation, could start eroding the levels of output and, hence, productivity. In the case of Spain, the past internal devaluation, together with the labour slack, leaves some room for productivity gains. In France and, especially, Italy, some moderation in workers' compensation is needed to increase the competitiveness of their labour forces.

Euro zone GDP growth should consolidate above 2.0%

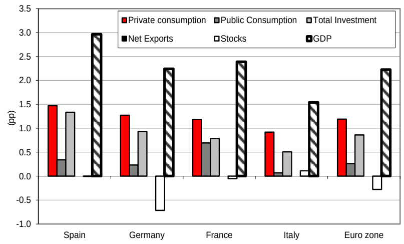
All in all, things are improving in the four largest Euro zone economies in a somewhat coordinated process. We have changed our 2018E and 2019E Euro zone forecasts accordingly:

Euro zone: We have raised our forecasts for 2018E (to 2.4% from 2.2%) and 2019E (2.2% vs 2.1% previously). In our view, the acceleration of GDP growth in 2017 was fully supported by the significant improvement in fundamentals in recent years. We now believe those better fundamentals should keep Euro zone GDP growth above 2.0% in the coming years. Both internal demand and net exports are likely to contribute to GDP growth in 2018-19.

Germany: We have lifted our GDP forecasts to 2.4% for 2018E (2.1% previously) and to 2.2% for 2019E (from 1.9%). The economic performance has been very good so far, with internal demand remaining robust and the external sector also doing well. Upward revisions of some previous quarterly numbers pushed our 2018 forecast higher, due to base effects. We expect the strength of internal demand to continue in 2018E-19E, with investments accelerating sharply due to the capacity problems the economy is now experiencing.

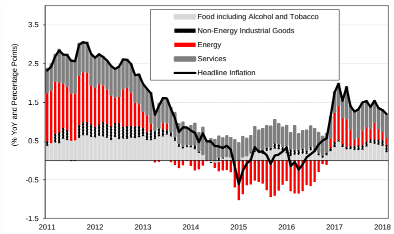
France: Our GDP estimate climbs to 2.4% for 2018E (2.3% previously) and remains at 2.4% for 2019E. French GDP has turned the corner by passing the 2.0% level. We think the fundamentals have changed and are now strong enough to support GDP growth rates of c2.5% on a sustainable basis in the coming years. Internal demand is the main source of growth, while net exports are now less negative than in the past.

Chart 37: GDP breakdown for 2019E



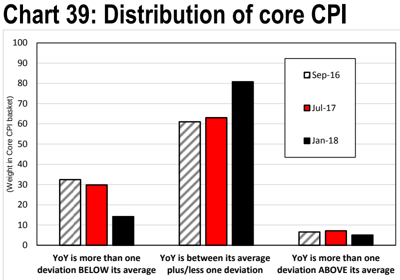
Source: Santander estimates.

Chart 38: CPI and breakdown



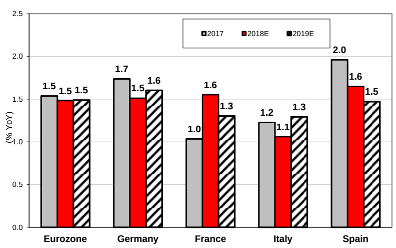
Source: Eurostat and Santander.

Chart 39: Distribution of core CPI



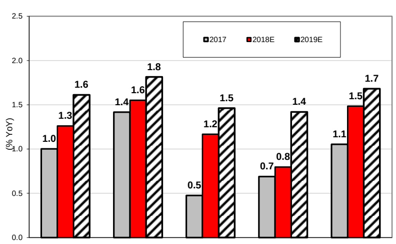
Source: Eurostat and Santander.

Chart 40: Headline inflation forecasts



Source: Eurostat and Santander estimates.

Chart 41: Core inflation forecasts



Source: Eurostat and Santander estimates.

Italy: After an acceleration in 2017, we estimate that GDP growth could consolidate at around 1.5% in both 2018E (1.6% before) and 2019E (unchanged). We estimate that the fundamentals are good enough to keep private final sales positive, mainly driven by investment and exports. However, the political uncertainty is a negative risk for this growth scenario.

Spain: We increase our 2018E GDP estimate to 2.9% (vs 2.8%) and still see 2019E growth at 3.0%. The Spanish economy should keep outperforming its European peers in 2018-19, with GDP growing by c3.0% in both years. The impact of the Catalan political crisis on the economy has proved to be smaller than we expected, which has led us to revise our 2018E number to 2.9% from 2.8% previously. Growth should still be driven by internal demand, with net exports no longer a drag, as they have been in the past.

In general, consensus forecasts for both 2018 and 2019 have not changed too much from those seen in 2017. In fact, the consensus revisions have been ‘reactive’ rather than ‘proactive’, that is, mostly made once encouraging data had been published. In that sense, we believe there should be upward revisions in coming months, with the upside more limited in the case of 2018 than in 2019.

Inflation: the key is in the CPI breakdown

Against this backdrop of consolidated economic recovery, deflation fears are definitely over for now and price indicator details point to increasing upward risks for inflation (mainly core inflation) going forward.

Indeed, Euro zone inflation averaged 1.5% in 2017, well above the 0.2% posted in 2016, mainly due to higher energy and food prices, while the contribution from core inflation was quite limited, reaching an average of 1.0% in 2017 vs 0.9% in 2016. That said, the stabilization of core inflation last year ‘hides’ significant changes in the breakdown that, in our view, show that risks are also biased to the upside for this component.

If we analyse all the minor CPI components and their distribution, we find that an increasing percentage of the basket presents an annual rate that is in line with its historical average. In January 2018, 82% of the Euro zone’s total inflation posted annual rates in a range of the average plus/minus one standard deviation, rising from 72% in July 2017 and 64% in September 2016, leaving 15% still below the average (down from 31% in September 2016). This phenomenon has been particularly intense in core inflation since last summer. In the period from July 2017 to January 2018, the percentage of core inflation in line with its historical average rose to 81% vs 63%, while 14% was still below average vs 30%.

At the end of the day, there is still clear downward pressure for consumer prices from some components with a relatively low weighting, but we can say that the bulk of the CPI basket is moving towards the right-hand side of the distribution. We believe this opens the door to the economic recovery translating more clearly into prices in coming months and we maintain our outlook for the main trends for Euro zone inflation and its breakdown. For the coming quarters, we expect the main news to be generalized higher rates of core inflation in Euro zone countries, against a backdrop of domestic risks biased to the upside.

Euro Rates Strategy: Correction leaves core rates looking expensive. We suggest curve trades and long 15y SPGBs

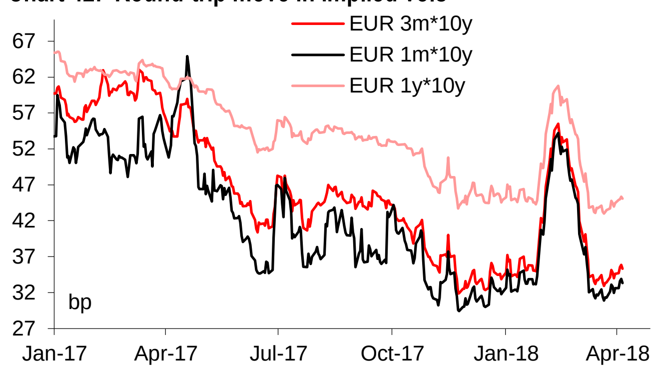
Luca Jellinek
(+44) 33 114 80133

- **Weaker stocks, leading indicators and slow inflation have helped EUR core rates correct lower, erasing roughly 50% of the preceding sell-off. Tighter policy, medium term, suggests higher rates but at a slow pace, like in 2017.**
- **We suggest positioning against some interesting yield curve dislocations that should not be exceedingly directional.**
- **Political and policy risk in Italy remains elevated, despite tighter BTP-Bund spreads. SPGBs have outperformed more clearly, thanks to supportive fundamentals. We like the 15y SPGB area as a spread-tightening trade.**

Rates corrected further on softer data; the bearish trend will likely remain a shallow one

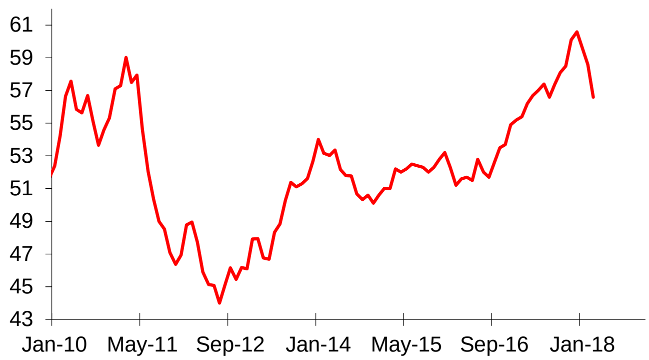
Price action in EUR rates continues to support our hypothesis that **the current bearish cycle is more protracted, as well as shallower, than other rising-rate periods**. The 10y Euribor swap rate rose steadily from mid-December to mid-February, increasing by roughly 40bp. Since then, it has corrected lower by roughly 20bp; a 50% retracement. Market-**implied volatility also corrected**, in this case back to the all-time lows set before the sell-off. The broad underlying reasons we see for such moderation are the caution exercised by central banks (especially the ECB) in reducing monetary policy accommodation and the still modest pace of reflation.

Chart 42: Round-trip move in implied vols



Source: Bloomberg, Santander.

Chart 43: A sharp drop in the manufacturing PMI



Source: Reuters-Markit, Santander.

Looking at specific events in recent weeks, that theme of a mixed environment for rates markets is still clearly evident.

- Global equity markets have been very mixed but with more bearish than bullish momentum, since late January. Oil prices have been firmer but are not really trending higher.
- Euro area data have shown a **deceleration in credit and monetary expansion**. From very high levels, sentiment indicators have pushed lower, including a sharp **four-point slump in the Euro area manufacturing PMI since the beginning of the year**.
- **Inflation has stagnated** in both the Euro area and the US. Although the latest flash CPI accelerated to 1.0% y/y, the **core measure, remained stuck at 1.0% y/y**.

Against that backdrop, **relatively hawkish monetary policy communication has struggled to make itself heard**. The Fed has hiked the target rate and signalled that more is to come (see the US section for more detail). The ECB has begun the (probably) very slow process of exiting QE, with the number of GC members calling for an end to bond purchases growing[1]. In recent sessions, the central bank factor has not really weighed heavily, however, arguably because of the aforementioned real-economy headwinds.

Another factor specific to EUR rates is the fact that **the APP faces substantive redemptions in Q2**, especially in April. As a result, despite the ECB's commitment to smoothing purchases, the gross amount of buying should be significantly higher than would be suggested by the net monthly addition of EUR 30bn to its APP holdings.

To sum up, where direction is concerned we make no material change in our year-end forecasts for higher rates. We expect the EUR 10y rate to rise from the current level of 0.96% to 1.35% by December. Market participants with long-term horizons might be interested in reducing rates risk at these levels. However, we haven less conviction in short-term outright short positions, with the 15y paying trade having hit our tightly-set stop levels.

Term structure dynamics are transitioning and so should curve positions

In mid-March, we wrote about the evolution of EUR rates term structure dynamics, suggesting that "*with ECB rate hikes no longer 'unthinkable', curve dynamics might be changing again*". Divergence between the slope of curve segments such as the 5s10s vs. the 2s5s or the 10s30s as well as the relative steepness of the front end vs. back end of the term structure suggest caution with curve trades in coming weeks / months:

- We would be more sceptical of, and therefore test more robustly[2], the sorts of steepening trades that, in 2016-17, served as a proxy to direction. We have an extant trade in the form of a **2-10-30y barbell**. This has been quite directionally correlated and remains close to entry levels, rather disappointingly, given the rally in 10y. It therefore makes sense to **close it**.

- Conversely, we would focus on barbell and slope trades with a low long-term correlation to direction but that have been pushed away from their mean levels due to flows or the temporary volatility spike. Table 3, below, shows some curve slope segments and barbell trades with their directional correlation over the past three- and one–year periods. The three-year Rich/Cheap is merely a deviation from the mean, while the one-year R/C, given the presence of stronger directional correlation, is relative to direction. All R/C levels are in bp.

Table 3: Higher-residual, less (M-T) directional EUR curve trades

'trade'	10f5y-5f5y	15f15y-5f5y	2-5-10y	2-5-15y	5-7-15y	5-7-20y	5f-10f-15f
dir correl (3y)	11%	12%	49%	27%	5%	8%	7%
dir correl (1y)	80%	78%	85%	82%	78%	75%	74%
3y R/C	-8	-9	10	11	4	4	-3
1y R/C	-6	-10	3	5	3	4	-3

Source: Bloomberg, Santander.

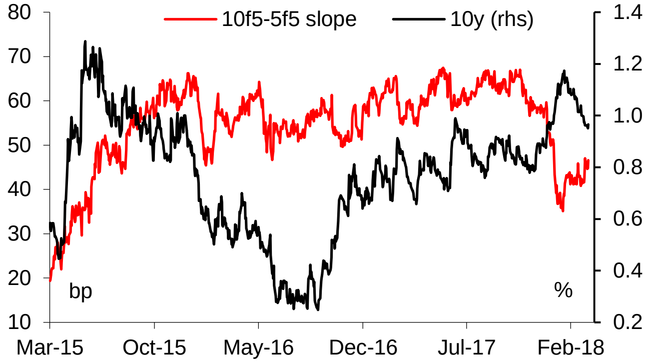
In practice, there are no trades *entirely* free of directional association but, on the other hand, the deviation from that short-term directional relationship is attractive enough, in our view, to suggest a decent trade potential. For instance, looking at the 10f5y – 5f5y slope (which is correlated to, but less directional than, the 10s15s slope) it has shown a 11% correlation to 10y rates

[1] The other small, but significant, signal was the removal of the sentence "*If the outlook becomes less favourable […] the Governing Council stands ready to increase the APP in terms of size and/or duration.*" From the March monetary policy statement.

[2] For instance, we would compare parameters under different timespans and different 'explanatory' rates for consistency and stability.

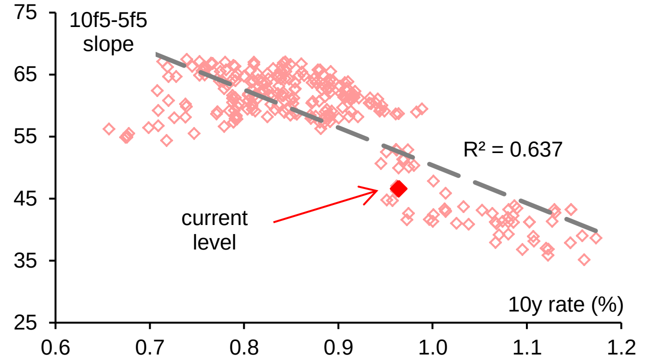
over a three-year period (60% to 2y rates). It is currently 8bp flatter than average. Using one year of data, the directional correlations are, respectively, 79% and 67%. The 1-year directional 'residual' is -6bp.

Chart 44: EUR 10f5y – 5f5y slope vs. 10y rate (last 36 months)



Source: Bloomberg, Santander.

Chart 45: EUR 10f5y – 5f5y slope vs. 10y rate (last 12 months)



Source: Bloomberg, Santander.

Any of the trades in Table aa above should appeal to the same sort of rationale. For tracking purposes, we will follow just two:

Trade idea

Pay EUR 10f5y fixed
Receive EUR 5f5y fixed

The current spread is 47bp, with a first target of 55bp. No hard stop, but re-examine at 42bp.

And

Trade idea

Pay EUR 5y and 20y fixed
Receive EUR 7y fixed

The current 50:50 spread is -26bp, with a target of -30bp. No hard stop, but re-examine at -24bp. Carry is minimally positive.

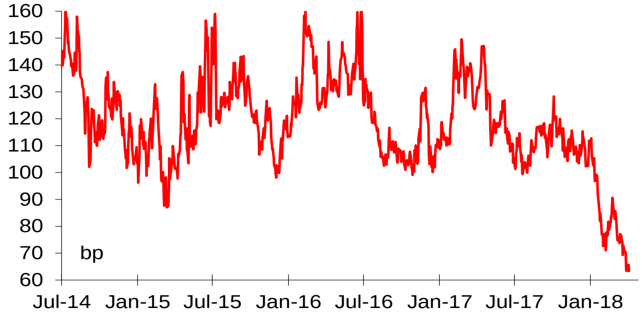
Periphery tightening continues, led by Spain

March was a good month for SPGBs, with spreads over Bunds pushing lower and printing the tightest levels since 2010. The 10y CMT spread is currently around 64bp. The latest leg in the yield convergence trend has been underpinned by Spain-friendly news flow:

- S&P upgraded Spain's rating from BBB+ to A- on 23 March and kept the outlook 'positive. This followed Fitch's upgrade in January.
- The growth outlook for 2018 was revised upward by the government (from 2.3% to 2.7%), matching private-sector figures.
- The 2017 figures show an improvement in the public-sector balance of ¾ % to 1½% of GDP, depending on the measure, allowing Spain to meet EC-set targets.

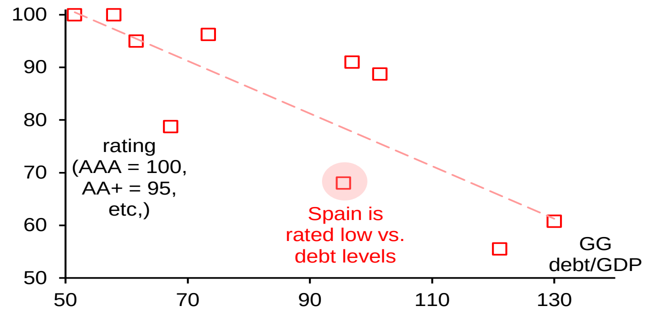
On that front, it seems likely that fundamentals will remain supportive. Spain's sovereign rating will next be reviewed on 6 April (DBRS) and 13 April (Moody's). We think either upgrades or changes in the outlook from 'stable' to 'positive' are likely. Beyond these short-term appointments, as we have remarked before, Spain's rating looks quite low, by EMU-wide standards, when compared to its public debt/GDP level and trajectory, so further upgrades can be expected. On the growth front, there is evidence of still strong domestic consumption and investment which, in an environment of robust international growth, adds up to above-trend growth. We expect real GDP to increase by 2.9% in 2018 and 3.0% in 2019.

Chart 46: Spain-Germany 10y interpolated spread –clearly broken through to a lower range



Source: Bloomberg, Santander.

Chart 47: Average sovereign rating vs. EC-forecast debt/GDP – 10 largest EMU issuers

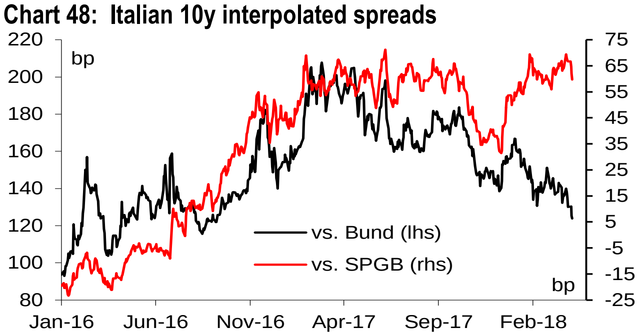


Source: EC, S&P, Moody's, Fitch, DBRS, Santander.

While Spain's performance has been rather straightforward both in terms of direction and underlying fundamentals, **Italian spreads have reflected a more complex situation**. On one hand, output and employment growth accelerated in 2017 and the fiscal balance is under control. On the other hand, the rate of real and nominal growth remains well behind other periphery issuers. Furthermore, the result of **recent elections** raises as yet **unanswered questions about political stability and economic policy**, given the pre-eminence of parties, like 5 Star and The League, which advocate policies that clash with EC/ECB orthodoxy.

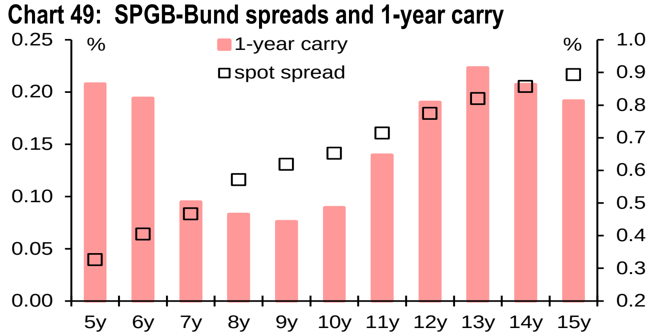
Relative top Spain, BTP yields have pushed back towards relative highs, while they have corrected lower vs. Germany. April should be a key month in terms of forming a government but, even if a multi-party majority is found, the policy aspect is set to remain a hot issue well into the second half of the year. We believe that BTP risk premia, despite being the widest between SPGBs, BTPs and PGBs, incorporate more event risk and, on that basis, **we would *not* position for BTP outperformance**, there.

Chart 48: Italian 10y interpolated spreads



Source: Bloomberg, Santander.

Chart 49: SPGB-Bund spreads and 1-year carry



Source: Bloomberg, Santander.

Our existing SPGB trades (30y and 5f5y spread convergence) have hit their targets and are therefore closed. However, in terms of overall market positioning and outlook regarding periphery, price action and discussions with investors suggest to us that, despite instances of profit-taking, **market participants as a whole are not yet willing to bring periphery holdings down to neutral**. On that basis, current spreads could be maintained or even reduced, in coming weeks. In such an environment, one area that we find stands out in terms of both outright yield pick-up (over Bunds) and carry is the **SPGB 15y** bucket (Chart 49). We would place tactical spread tightening trades in that location, with relatively tight stops, given the recent price action and entry levels.

Trade idea

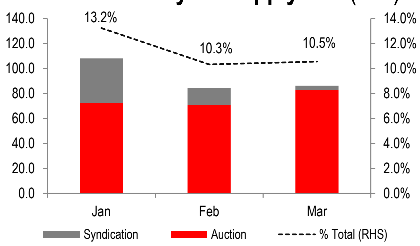
Buy	SPGB 2.35% Jul-2033
Sell	Bund 4.75% Jul-2034

The current outright yield spread is 86bp, with a target of 70bp. Set a stop at 95bp.

Euro government bond supply: YTD update

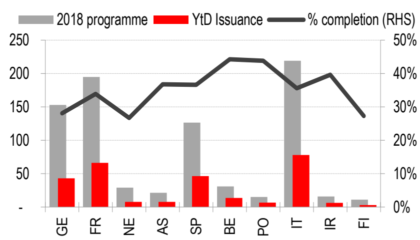
Edgar da Silva
(+34) 91 257 22 44

Chart 50: Monthly EZ supply-YtD (€bn)



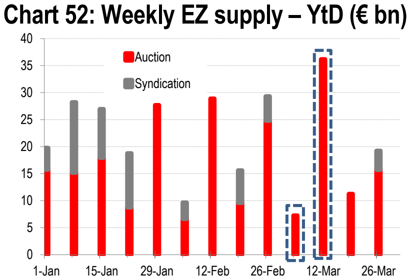
Source: Bloomberg

Chart 51: 2018 YtD issued vs. target



Source: Bloomberg

Chart 52: Weekly EZ supply – YtD (€ bn)



Source: Bloomberg

Table 5: YtD issuance completion vs. historical data

	2013	2014	2015	2016	2017	2018	Aver 13-17
GE	25%	27%	27%	29%	26%	28%	27%
FR	32%	30%	30%	29%	29%	34%	30%
NE	41%	42%	36%	27%	35%	27%	36%
AS	17%	16%	18%	37%	21%	37%	22%
SP	33%	33%	35%	33%	30%	37%	33%
BE	30%	43%	35%	28%	44%	44%	36%
PO	45%	37%	44%	48%	38%	44%	42%
IT	25%	26%	34%	27%	30%	36%	28%
IR	100%	40%	72%	48%	40%	40%	60%
FI	7%	33%	43%	41%	43%	27%	34%
TOTAL EZ (€)	29%	30%	33%	30%	30%	34%	30%

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

Over 30% completion of Euro area govie issuance

At the end of March, the Eurozone as a whole had covered 34.1% of its total average govie bond financing needs for 2018. This figure includes Germany's €2bn reduction in funding needs this year, versus the original plans published in December. According to the Finance Agency, this reduction will be applied to capital market auctions, so Germany's target for 2018 drops from €155bn to €153bn. Taking the German information into account, EUR issuers' combined target for the year is now €817bn (€819bn before).

Year-to-date, EUR issuers have sold more than €275bn of bonds via both ordinary auctions (c.€226bn) and syndicated deals (€53bn), representing 34.1% of our revised 2018 issuance target (€817bn). As seen in Chart 50, EUR issuers sold 10.5% of their combined target in March (slightly above February's 10.3% placement) with combined bond auctions and syndicated deals increasing by about €2bn, versus the February figures, perhaps caused by diminished concerns over the political scenario in Europe and central bank action uncertainties.

As at 31 of March, Italy is at the forefront in terms of YTD issuance, having placed €77.9bn. France, with €66.1bn, is second, Spain comes in third, with €46.3bn of bonds sold, and Germany is in fourth place, with €43bn (Chart 51). Belgium is a distant fifth, having issued €13.7bn last month, followed by Austria and the Netherlands, with €7.9bn and €7.7bn, respectively. Portugal (€6.6bn), Ireland (€6.3bn) and Finland (€3bn) are at the bottom of the ranking.

Table 4: Total issued in EZ in 2018, by country (updated as at 31 March)

	GE	FR	NE	AS	SP	BE	PO	IT	IR	FI	TOTAL EZ (€bn)
YtD auctioned issuance	43.0	62.6	7.7	3.9	30.3	4.2	2.6	68.9	2.3	0.0	225.6
YtD syndicated issuance	0.0	3.5	0.0	4.0	16.0	9.5	4.0	9.0	4.0	3.0	53.0
YtD Issuance	43.0	66.1	7.7	7.9	46.3	13.7	6.6	77.9	6.3	3.0	278.6
2018 programme	153.0	195.0	29.0	21.5	126.3	31.0	15.0	219.0	16.0	11.0	816.9
% completion (RHS)	28%	34%	27%	37%	37%	44.3%	43.9%	36%	40%	27%	34.1%

Source: Bloomberg, Treasury Agencies

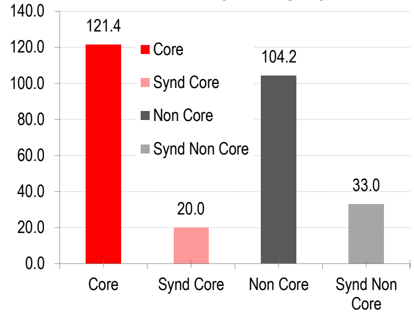
In terms of YTD completion rates by country, as shown in Table 4, all of the Euro zone issuers have surpassed the 25% mark. In March, Belgium leads the pack, having already completed 44.3% of its planned 2018 issuance. Portugal (43.9%) is second, followed by Ireland (40%). Austria and Spain are not far behind (both at 37%), while Italy is in fifth place, at 36%, closely trailed by France (34%). The other Euro area issuers above the 25% mark are Germany, Finland and the Netherlands (28%, 27%, and 27%, respectively).

In terms of weekly averages, Euro zone issuance decreased from €22.8bn in February to €21.4bn in March. The region's auction activity has been zig-zagging since the beginning of the year, while the syndication activity took almost a break in March (France was the only issuer with its 18y linker for €3.5bn), partly explaining the drop in the Euro zone's weekly average issuance last month. As shown in Chart 52, so far this year, the week beginning 12 March saw the biggest volume of supply, with €36.2bn placed in bond auctions. On the other hand, the lowest volume year-to-date was seen the previous week (that commencing 5 March), at just €7.2bn. This lower bound could stand until we hit the summer months (especially August), when we expect the usual scant bond supply.

When comparing 2018 to last year's completion rates (see Table 5), all the countries, bar Finland, the Netherlands and Ireland, have exceeded last year's average, and Austria leads the way at 16pp more than in 2017. Note that Belgium, Spain, Italy and France are issuing at a faster pace than in the last five years, contributing to the Euro zone's combined average also reaching its fastest in the last five years. Ireland, on the other hand, has issued much less paper YTD than at this point of the last five years.

Periphery following core countries very closely

Chart 53: Issuance by category – YtD



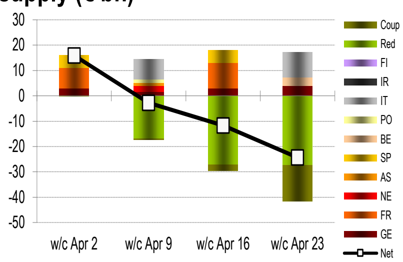
Source: Bloomberg

At this point, total core (and semi-core) supply (Germany, the Netherlands, France, Belgium, Austria and Finland) slightly surpasses that from the periphery (Italy, Spain, Ireland and Portugal). At the end of March, core issuance accounts for 50.8% of the total, the equivalent of €141.4bn, while periphery supply makes up the remaining 49.2%, or €137.2bn. As seen in Chart 53, the core countries have auctioned 1.17x more than the peripherals (€121.4bn vs. €104.2bn) so far in 2018, while the non-cores have placed 1.65x more via syndicated deals than their core counterparts (€33bn vs. €20bn).

In the same period of 2017, the European periphery issued €132.5bn (€102.5bn via auctions and €30bn through syndicated deals), vs. the €137.2bn (€104.2bn and €33bn, respectively) placed so far this year. This year's number is about €5bn higher than last year's, highlighting that the non-cores have been more active in both the auction and syndication channels this year. The core issuers sold €140.5bn through the end of March 2017 (€114.5bn in auctions, €26bn syndicated), versus €141.4bn (€121.4bn and €20bn, respectively) this year, or around 1% more than last year. The core countries' syndicated activity has fallen this year, while their auction activity has risen by 6%, perhaps explained by France and Belgium issuing faster in 2018, as mentioned above.

Supply dynamics: Negative net euro supply in the next four weeks

Chart 54: Expected EUR bond net supply (€ bn)

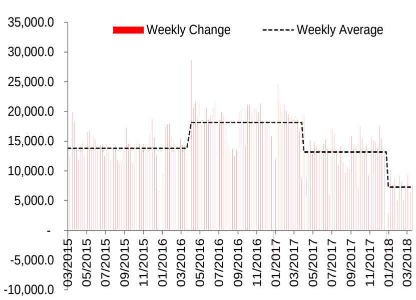


Source: Bloomberg

Over the next four weeks, we expect around €68bn in new auctions. On our numbers, France should issue €19bn, Italy €18bn (not counting a possible BTP Italia), Germany €11.5bn and Spain €9bn. Portugal could sell around €1.3bn, while the Netherlands plans to reopen its 10y DSLs for up to €2.5bn. Austria and Belgium are scheduled to sell bonds in April, while Ireland and Finland might issue in the primary market next month. All this supply will be completely offset by hefty bond redemptions (€71.5bn) from Germany, France and the Netherlands, and coupon payments (€17.2bn), mostly coming from France (Chart 54). Consequently, EUR net issuance will stay in negative territory for the next four weeks, not counting the ECB, which will take €30bn out of the bond market next month as part of its EAPP objective from January to September, further supporting the European bond market in the following weeks.

The ECB's EAPP update

Chart 55: The ECB's EAPP portfolio: weekly change vs weekly average(€bn)



Source: ECB, Bloomberg, Santander

On 4 April, the ECB published an update of its Extended Asset Purchase Programme (EAPP) holdings, which includes the purchases settled as at 30 March. According to the latest report, its **PSPP** holdings now stand at €1.95trn, **CBPP3** holdings now amount to €250bn, the **CSPP** totals €149bn and **ABSPP** holdings have reached €26bn, for a total EAPP portfolio of €2,369.1bn. The ECB's March weekly purchasing average is €7.6bn, slightly above of the €6.9bn seen in February, and also higher than the €7.3bn overall weekly average since January 2018.

By country (Table 6), the latest information available is a breakdown of the PSPP debt security holdings published by the ECB on 4 April. The March figures show that public sector purchases totalled €20.8bn, €18.7bn of which were EUR govies, regional and agency debt (around €911mn less than in February), while the remaining €2.1bn are supranational debt

(€116mn less than in the previous month).

The March country breakdown shows activity slowing down in most countries, with Lithuania being the most notable exception (€204mn more than last month), followed by Malta (with the second-largest increase, from €5mn in February to €31mn in March). With respect to Germany, France, Italy and Spain, the ECB's asset purchases decreased by €313mn, €234mn, €216mn and €106mn compared to February, respectively, with the big four's combined March purchases (€14.9bn) continuing to concentrate more than 70% of the month's PSPP buying (72% in February and in March).

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

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

Source: ECB, Santander

Stuart Green
(+44) 33 114 80239

- **February decline in UK CPI inflation reflected weakness in both goods and services prices**
- **We continue to argue that the MPC's analysis of the exchange rate pass-through effect is overly hawkish, and look for a sharper slowing of inflation within the import-sensitive areas of the CPI**
- **Base effects suggest downward momentum will build during H2-18, with UK CPI seen falling below 2% before the end of the year.**

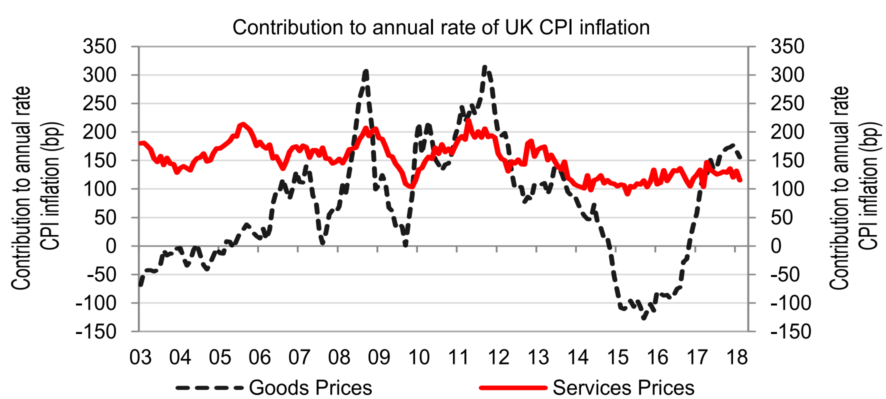
UK Inflation: February's fall was a taste of things to come

UK consumer price inflation surprised to the downside in February, falling to 2.7% from 3.0% previously, and reaching the lowest level since July 2017 in the process. Rather than simply reflecting the 'normal' volatility of the inflation series, we believe that the factors behind this slowing of price growth are likely to prove of fundamental importance to the monetary policy discussion, with two elements in particular standing out.

First, we argue that the February data provided compelling evidence of a relatively rapid pass-through of imported inflation into consumer prices, placing further scrutiny on what we believe to be the Bank of England's overly-hawkish analysis of this issue. Second, we believe that a further key feature of the UK's February CPI data related to the weakness of price pressures across the service sector, with a core measure of CPI services inflation (excluding education, air fares and package holidays) falling to the lowest level since September 2015.

Although Chart 56 suggests that goods prices will likely remain the key influence upon the trajectory of UK consumer price inflation overall for the foreseeable future, we believe that this continued weakness of services inflation warrants increased recognition. While the Bank of England's Monetary Policy Committee (MPC) continues to talk up the prospects of an imminent acceleration of wage inflation –even though the related survey data remains unconvincing, in our view– we argue that policymakers should now acknowledge that any such build-up of domestically-generated inflation will now commence from a lower-than anticipated level. Indeed, given our assumptions around the likely speed of the exchange rate pass-through effect, we believe that UK consumer price inflation is now set to fall below the 2% target before end-2018, and argue that an acceleration of wage pressures will be increasingly required to prevent an inflation undershoot through 2019.

Chart 56: Goods prices have proved the key driver of UK inflation, with services static



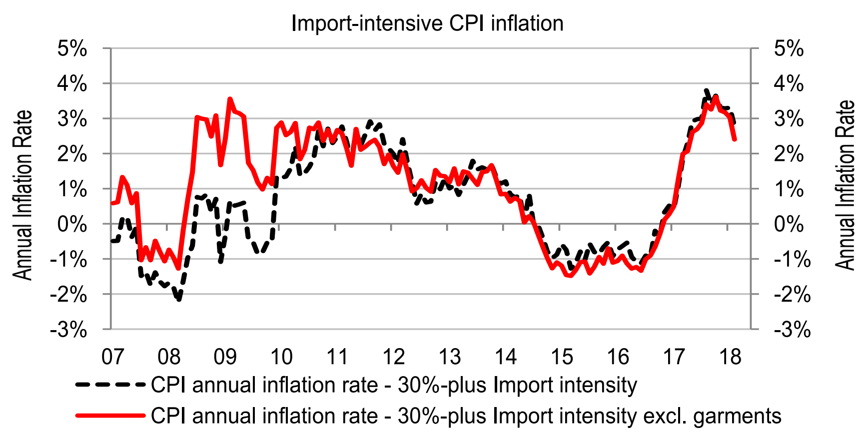
Source: ONS, Thomson Reuters Datastream, Santander.
Note: Chart shows the contribution of goods and services prices to the annual rate of consumer price inflation. Goods prices account for 51.9% of the weight of the CPI, and services 48.1%.

Pass-through effect moves further away from 2007 playbook

As stated above, however, we believe that goods prices are still likely to exert the greatest influence on the near-term profile of UK inflation, with the February data providing strong evidence, in our view, of how the exchange rate pass-through effect is now progressing at a faster rate than the MPC's projections appear to have assumed.

As we have outlined in previous research documents (see, for example, '[Sub-2% CPI in 2018 – A pipe dream or in the pipeline?]', published 8 September 2017), we believe that the MPC's assumption of a relatively prolonged, gradual pass-through of higher import costs into consumer prices has likely been influenced by the behaviour of UK inflation following the 2007 sterling depreciation, and an apparent failure to acknowledge the distortive influence of clothing prices upon measures of import-sensitive prices during this period. We argue that once methodological changes made to the clothing component of the CPI in 2011-12 are considered – reforms designed to remove what was perceived to be an exaggerated deflationary influence upon reported inflation rates– a very different view of the 2007-10 pass-through effect is presented. Indeed, we believe that the current data are, in effect, confirming the distorted nature of the inflation figures from the 2007-10 period, and argue, in turn, that a pass-through duration of closer to two years should be expected, rather than the three to four years that the MPC currently appears to be assuming.

Chart 57: We argue that clothing prices distorted perceptions of the pass-through effect which followed the 2007 sterling exchange rate depreciation



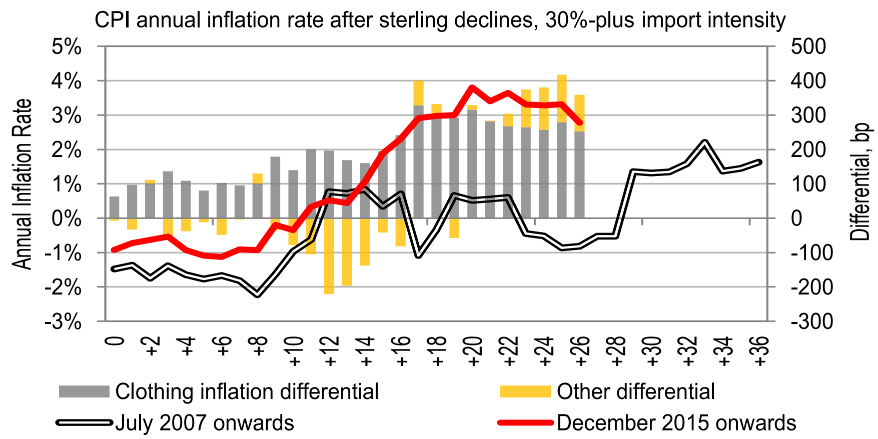
Source: ONS, Thomson Reuters Datastream, Santander.

In order to highlight this distortion more clearly, Chart 57 illustrates the annual inflation rate of a calculated series which contains each element of the UK CPI with an estimated direct import intensity of 30% and above, including the clothing/garment component (COICOP category 03.1.2). According to this calculated series, and following the 2007 depreciation of the sterling exchange rate, inflation within the most import-intensive areas of the CPI basket did not peak until 2011, indicating a prolonged pass-through effect. However, when removing the clothing/garment data from the analysis –data which were reformed by the ONS in 2011 in order to address a perceived, deflationary distortion– Chart 57 suggests that a pass-through effect of roughly two years' duration had in fact developed following the 2007 sterling depreciation, and the data from the current period would appear to suggest this relationship has held following the late-2016 decline in the pound. Indeed, following the release of the February 2018 CPI data, the annual inflation rate of this adjusted series (30%-plus import intensity excluding garments) has already fallen by c120bp from its October 2017 peak.

Import-sensitive inflation is already in retreat…

Taking the analysis a stage further, Chart 58 provides a more detailed illustration of the different behaviour of this import-intensive inflation rate in the aftermath of the July 2007 decline in the sterling exchange rate, and that which has followed the weakening of the pound to have developed from late-2015 onwards. Following a similar change in the inflation rate over the first year of the periods studied, a marked difference in the behaviour of this import-sensitive inflation index has subsequently developed, and Chart 58 also illustrates the proportion of this differential which can be attributed directly to the clothing element of the CPI. Currently, some 250bp of the 360bp differential between the inflation rates show in Chart 58 relates to the clothing element alone (clothing prices reducing inflation during 2007-10, and boosting it from December 2015 onwards). We believe this statistic neatly highlights how a failure to correct for the known distortions surrounding clothing prices during the 2007 to 2010 period may lead to a biased analysis of the current inflation outlook for the UK.

Chart 58: At face value, the current pass-through effect is developing much faster than in 2007



Source: ONS, Thomson Reuters Datastream, Santander.
Note: Chart shows the evolution of a calculated, import-intensive CPI index in the months following the July 2007 and December 2015 depreciations of the sterling exchange rate. The difference between the inflation rate in the two episodes that can be attributed to clothing or other prices is also detailed.

…and the Bank of England's own survey suggests the pass-through effect is nearing completion

Overall, we continue to look for a sharper deceleration of the most import-intensive areas of UK inflation through 2018 than that expected by the MPC, with the Bank of England's February Inflation Report projecting an average CPI inflation rate of 2.42% in Q4-18. Indeed, we believe that evidence from the Bank of England's latest Agents' summary of business conditions survey supports our argument. Aside from reporting a further decline in the inflation rate of imported finished manufactured goods, the Q1-18 Agents' survey also contained additional detail on corporate pricing intentions for the coming year and, in particular, the perceived ability of corporates to pass on higher import costs to their customers. The surveyed firms remained uncertain of the time horizon over which some 35% of the increased import costs could be passed onto customers, and some 40% of the respondents expected to incur a permanent hit to their margins. But, for the 65% of these higher import costs for which definitive plans existed, the survey respondents suggested that 52% of the increased costs had already been passed on to customers, with a further 10% expected to be passed on over the coming year, while some 3% of the higher import costs were expected to be passed on over a period of more than a year.

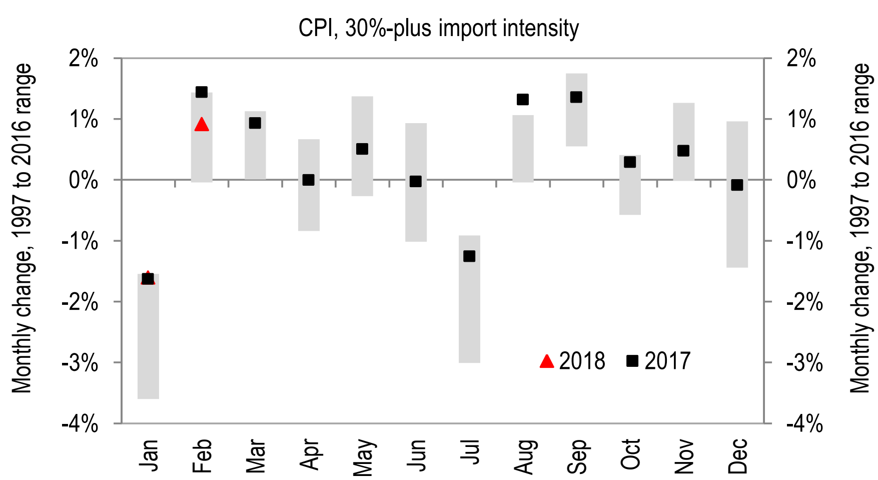
Base effects suggest downward momentum to gather pace in H2-18

If the momentum behind import cost-related increases in consumer prices has now faded (as we believe), then an analysis of the monthly changes recorded in import-intensive CPI prices in 2017 –and the base effects created– should offer a useful guide as to how a declining pass-through effect may influence UK CPI inflation overall. Chart 59 presents such an analysis for the calculated 30%-plus import intensity CPI series shown in Chart 57, detailing the monthly changes recorded in 2017 and in 2018 to date, as well as the range of monthly price changes registered between 1997 and 2016.

We believe that this information neatly highlights the prospect of a weak CPI figure being reported for February 2018, given that the price increase registered in February 2017 was in fact a record, and three times the monthly average for the series. In the event, we calculate that this 30%-plus import intensity series accounted for 14bp of the 28bp decline in the annual rate of CPI inflation recorded in February 2018, despite representing just over a quarter of the weight of the index.

Given the unusually large price rise recorded in March 2017, Chart 59 also highlights the scope for the import-intensive areas of the CPI to push overall inflation lower again in March 2018, before less extreme base effects are then seen as surrounding the April to June 2018 releases. However, with unusually strong pricing being observed between July and October 2017, we expect these import-intensive components of the CPI to resume their downward pressure on consumer price inflation overall through H2-18, culminating in a move towards –and likely below– the 2% level by the end of the year. Overall, we expect a declining level of imported price pressures to expose the 'soft underbelly' of UK inflation in the coming months and, given the weak 'starting' level of services inflation –core services CPI stood at just 2.05% in February 2018– we argue that a modest acceleration of wage growth through 2018 should not be the cause of any tightening of monetary policy by the MPC.

Chart 59: Unusually large increases in import-intensive CPI prices were recorded between July and October 2017



Source: ONS, Thomson Reuters Datastream, Santander.
Note: Chart shows the monthly changes recorded in 2017 and YTD of a calculated CPI series containing each component with an estimated direct import intensity of 30% or more. Chart also shows the range of monthly price changes recorded between 1997 and 2016.

UK Rates Strategy: Steepening risks to rates and basis lie ahead

Adam Dent
(+44) 33 114 80240

- **The UK has tracked the bullish corrections in other rates markets**
- **Pricing for an imminent BoE Bank Rate hike has stood out as an unusually constant feature through the recent market swings**
- **We believe the market is increasingly complacent about a very short and sharp hiking 'cycle', despite the UK's faltering macro data**
- **We continue to recommend steepeners such as 1s5s OIS and 5s10s, although the bull-flattening trend may continue a little longer**
- **FRA-OIS basis spreads have widened in the UK, catching up with the earlier move in short US tenors and overtaking in the long end**
- **We believe that widening is more likely to prove sustainable in long, rather than short, tenors, which seem more driven by US moves**

Long-term rates have been in decline, shorts stay anchored

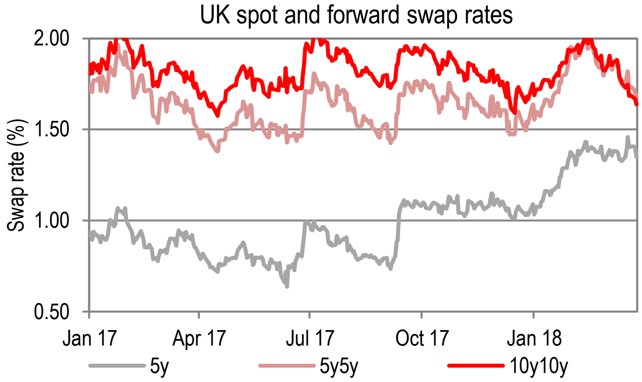
Our rate forecasts over the next two years have barely shifted since the time of our *Year Ahead* report back in December, and the central UK macro scenario behind our forecasts remains the same: steady but unspectacular economic growth, decelerating inflation (explored in detail in the UK Economics section, above), no material acceleration in wages and gradual progress towards an apparently fairly smooth Brexit. We also still see some of the toughest decisions and crunch points around Brexit and the accompanying volatility, such as on the Irish border, as yet to come.

We have slightly trimmed our 10y+ rate forecasts for the next two quarters, to reflect UK curves' determination to flatten over recent weeks. This flattening brought with it a reduction in where markets believe UK long-run neutral rates lie: seemingly closer to 1.5% than the 2.0% we previously anticipated, and which the market only briefly touched in February (Chart 60). Very long-term forwards, such as 15y15y, are even more depressed, slipping below 1.50%.

Stripping out the strong Libor-OIS basis widening in recent weeks gives an even weaker profile for near risk-free rates, with the 15y15y forward OIS rate hitting just 1.10%, the lowest ever aside from the immediate aftermath of the EU referendum (when a second rate *cut* was being threatened by the MPC).

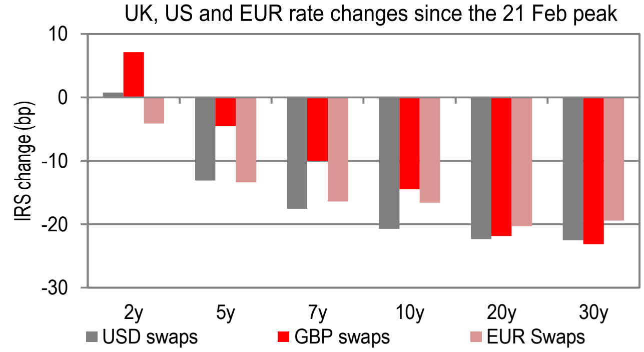
We do not attribute this decline to UK-specific developments, but see it as reflecting global curve flattening trends (Chart 61). Rather, the UK's deviation from the other markets has come at the front end, where market expectations

Chart 60: Short rates have been fairly stable



Source: Bloomberg, Santander.

Chart 61: UK rates; finally going their own way, but only at the very front end and in a hawkish direction that we disagree with



Source: Bloomberg, Santander. Changes from 21 February-29 March.

for a BoE hike next month have been almost the only constant. The implied odds have held above 80% throughout March, irrespective of developments in the news and other areas of the market.

We remain sceptical on the case for a BoE Bank Rate hike

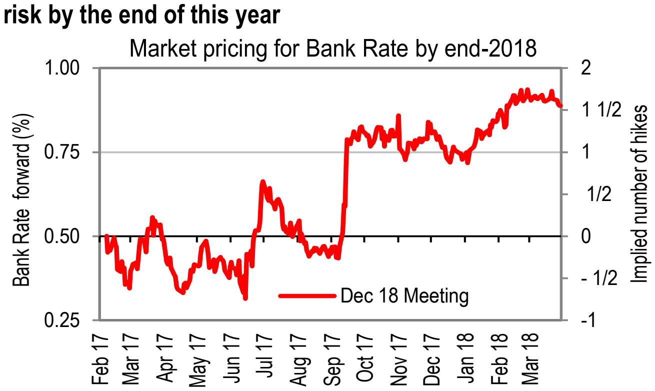
The implied timing of the UK's second future hike has moved around more than the first, but has remained within a February-May 2019 window, with about 1½ priced by the end of this year (Chart 62). Pricing for further hikes has diminished even further over the last month, as part of the global decline in long-run rates outlined above, and the third hike has now receded to at least autumn 2020. 'Two and done' looks like being an increasingly accurate description of the situation in the market.

While we accept that the BoE's MPC does seem inclined to raise rates fairly soon, we are not convinced that the Committee is necessarily as set on the May meeting as the market is, and see the latest economic data as reinforcing the argument against the need to lift rates. Crucially, we continue to argue that the MPC's analysis of the exchange rate pass-through effect is erroneous, and look for a sharper slowing of inflation within import-sensitive areas, that would raise the prospect of below-target inflation by year-end, as set out in the UK Economics section above.

The 2s5s curve has deviated even further from its historical relationship with the very front end of the UK curve over the last month, caught between the fixed hike pricing over the coming year and the global downtrend further out.

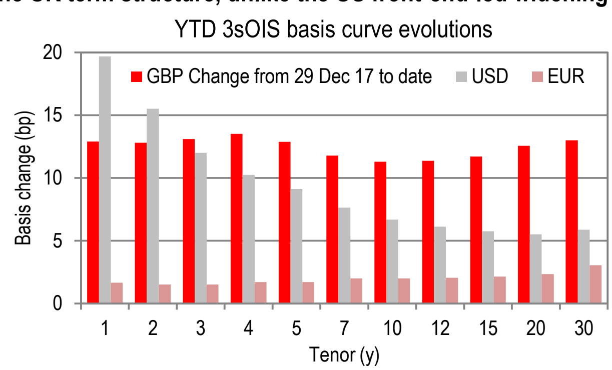
Our 1s5s OIS steepener recommendation from the last edition of our *Interest & Exchange* is now even flatter than where we started, but we find the arguments in favour of steepening correspondingly more compelling here: either the MPC is determined to 'normalize' rates regardless of mixed economic signals, in which case the market should come to believe in a longer tightening cycle, or the Committee will once again pull back at the last moment, and the putative cycle should be pushed back altogether. For investors who agree with our domestically-focused logic but are concerned that the bullish correction in global rates can go a little further, we think hedging with EUR and/or USD flatteners would make sense. We still believe the trend of rising rates will reassert itself over the medium term, but acknowledge that the recent downward momentum may persist in the short run, as discussed in the EUR Rates section of this report).

Chart 62: Market pricing implies a second BoE hike is a serious risk by the end of this year



Source: Bloomberg, ICAP, Santander.

Chart 63: Libor-OIS basis widening has been similar all across the UK term structure, unlike the US front-end-led widening



Source: Bloomberg, Santander. Changes over 29 December-29 March.

Progress towards Sonia adoption adds to basis pressure

Much attention has been paid to the explosive widening of the FRA-OIS basis in the US and, more recently, the UK (Chart 63). The reasons behind the US basis move remains unclear, in our view, but we chiefly attribute the UK's to a combination of spill-over from developments in the US, focused on short tenors, plus pressure in the long end from the UK's LDI investor base making moves towards Sonia as its reference rate. We anticipated a basis steepening influence from Libor-Sonia migration in an article last August, although we did not see the equally strong front-end widening pressure.

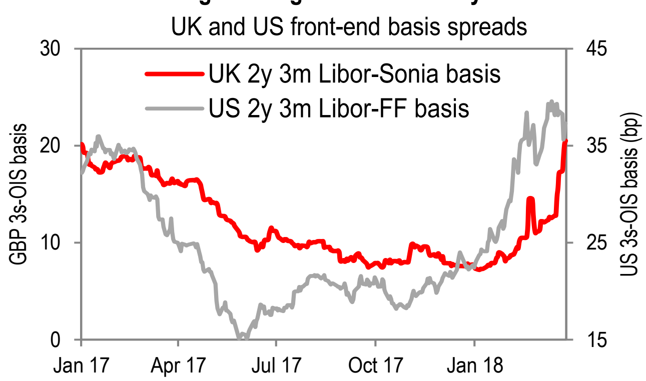
UK T-bill stocks have been more stable than those in the US, as HM Treasury's annual self-assessment tax windfall in January has reduced the short-term cash needs (Chart 65). Dynamics in that market. Therefore, do not seem such a reason for GBP basis widening as in the US. However, last week's credit data from the BoE showed that the net supply of Commercial Paper (CP) by UK issuers totalled £8.1bn in February, the highest for six years and the fourth highest on record. Although still seemingly a small number by gilt market standards, and covering all currencies rather than just the sterling market, at the margin that supply upswing may have contributed to the rise in GBP money market rates and Libor.

Based on these explanatory factors, we see the long-end widening as likely to persist or, indeed, to increase as RFR reform gains more momentum, particularly once the Sonia reform takes effect from 23 April. Another significant step down that road will come when LSE Curve Global launches its planned 3m IMM Sonia futures, and associated Inter-Commodity Spread contracts vs. the short sterling (Libor) strip. That will make a much more familiar (and directly convertible) substitute for the existing strip than ICE's thinly-traded ICE 1m Sonia futures (Fed Funds-style, launched in December 2017), and could increase liquidity across Sonia products by facilitating dealer hedging.

The fate of the short-end basis, on the other hand, likely rests on trends in the US and, to a lesser extent, sterling issuers' continued interest in CP funding. We, therefore, do not have a strong view on those spreads, although the sheer sharpness of the widening and the fact that GBP basis widening has caught up with the US's head start (Chart 64) lead us to see some reversal as more likely than a continuation.

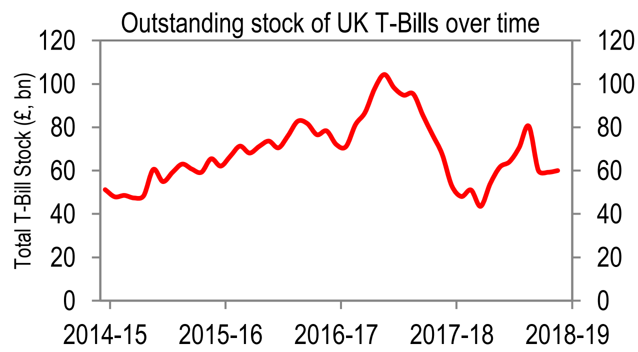
Despite the dramatic scale of the basis move, it has had a neutral effect on UK curve trades like our 1s5s, with the GBP 2y and 5y basis having moved roughly in parallel this month (a contrast with the US basis flattening profile.

Chart 64: Short-end UK 3sOIS basis spreads have caught up with the US widening that began earlier in the year



Source: Bloomberg, Santander.

Chart 65: UK T-bill stocks have declined since a peak in December, unlike the acceleration in US issuance



Source: DMO, Santander.

Stuart Bennett
(+44) 33 114 80134

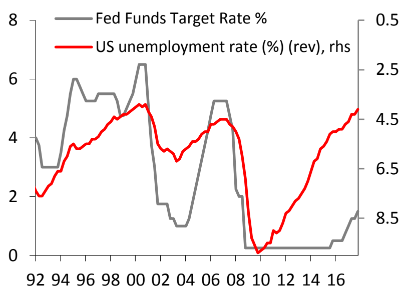
Taken from our latest FX Compass, published 22 March

USD – May the 'fourth' not be with us?

The USD has remained weak. Selling USDs seems to remain the FX market's default position, but we still think that it has adopted too negative a stance on the currency. US political and trade concerns continue to weigh, but strong fundamentals and the further expected Fed rate hikes provide no justification for the scale of the sell-off, in our view.

As expected, the Fed hiked US rates at the March FOMC. The 25bp increase took the Fed Funds target range to 1.50-1.75%. In addition, the 'dot' plots pointed to a faster pace of rate hikes in 2019 and 2020, although they still suggest only three rate hikes in total during 2018, rather than four.

Chart 66: Strong US fundamentals and expected further Fed rate hikes, should be USD positive



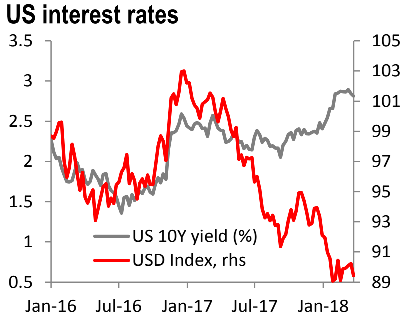
Source: Bloomberg, Santander

The Fed's economic forecasts continue to paint a bright picture for the US economy. The 2018 GDP forecast was revised up to 2.7% from 2.5%, with the 2019 forecasts lifted to 2.4% from 2.1%. Unemployment is expected to drop to 3.8% this year and to 3.6% in 2019-20. The unemployment rate in February 2018 was 4.1%. Despite the better outlook for activity, there were only small changes to the Fed's inflation forecasts: the core PCE measure is expected to be 1.9% in 2018, unchanged from the December forecasts, and the 2019 and 2020 forecasts were revised up slightly to 2.1% from 2.0%.

Overall, we think the expected combination of accelerating US growth and persistent rate hikes over the next three years is USD positive. However, the USD actually fell following the Fed announcement, as Fed Chair Powell's rhetoric was not considered hawkish enough, as he indicated that there was little in the recent data to suggest that inflation was about to accelerate, and with the market disappointed that there was no clear signal on a fourth Fed rate hike in 2018

Despite these factors, the USD's sell-off following the FOMC, and for that matter over the last few months, still seems counter-intuitive, with the market willing to aggressively sell the USD even as, in our opinion, fundamentals point in the opposite direction.

Chart 67: Never the twain? – USD and US interest rates



Source: Bloomberg, Santander

Admittedly, USD bears will point to US politics, trade friction and the likely adoption of a less loose policy by the ECB as reasons to sell the USD. President Trump's recent sacking of key members of the administration has raised some concerns. However, after over-reacting to Eurozone political risks during the last few years, the market may be better advised to adopt a more cautious stance with regard to US politics.

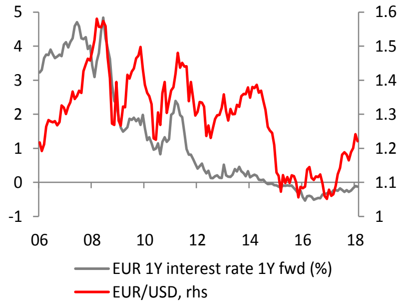
In addition, the risk of a trade war, as the US threatens to place tariffs on its trading partners' exports has also been viewed as USD negative. However, a 'trade war' would be bad for global activity, and not solely a USD negative.

Indeed, given that the US runs a large current account deficit, a reduction in these outflows could be deemed USD positive. However, given the slew of countries that the US appears to be exempting from its metal tariffs and the more conciliatory rhetoric coming from the NAFTA talks, the market's response to trade fears may also be overdone.

Finally, even after ECB asset purchases end in September 2018, Euro area policy will remain very loose. We do not believe the ECB will hike rates until Q2-19. Given that the Fed is likely to hike a further 4 or 5 times before the ECB's first move, it still seems perverse for the market to sell the USD aggressively against the EUR amid such a policy outlook backdrop.

EUR – Holding on

Chart 68: EUR/USD may already have priced in next year's expected ECB rate hike



Source: Bloomberg, Santander.

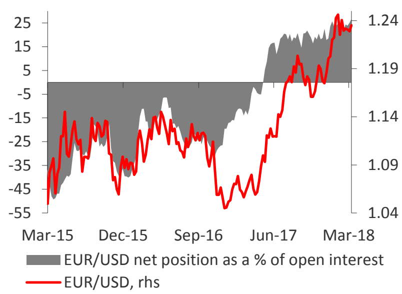
The EUR has stayed firm over the last month, but has not been able to push above its 2018 high. Good economic data continue to provide support, but no longer appear sufficient to pull the currency higher. The ECB seems more confident about the outlook, but is unlikely to hike interest rates until mid-2019. Hence, the prospect of other central banks reducing their own stimulus measures sooner could imply that strong EUR gains will remain difficult to generate over the coming months.

As expected, the ECB kept its monetary policy unchanged at its 8 March meeting. The Bank reiterated that it expects interest rates to stay at present levels well beyond the end of its asset purchase programme. It also confirmed that those asset purchases will continue until September 2018, or beyond, if needed.

The FX market's focus was on the Bank's decision to remove the reference to being willing to increase asset purchases in terms of size or duration. Draghi later downplayed the importance of the change, but the FX market viewed it as a hawkish step and a sign that the ECB is becoming more confident about reaching its goals.

Our forecasts for the ECB remain unchanged, namely that asset purchases will continue until September 2018, be tapered in Q4-18, and with a rate hike coming in mid-2019. But, given the hefty EUR gains since May 2017, would these be enough to propel the EUR even higher? In the near term, we think not.

Chart 69: Going long again – EUR/USD speculative position as a % of open interest*



Source: CFTC, Bloomberg, Santander.
*Open interest equals total long and short contracts.

Admittedly, many EUR crosses seem to have diverged from, and been much stronger than, interest rate differentials would suggest. But the combination of gradual/cautious changes by the ECB, compared to earlier policy changes by other central banks (the Fed, BoC, Norges Bank and, possibly, BoE) could contain further EUR gains.

The ECB forecasts growth of 2.4% in 2018, but then slipping to 1.9% in 2019 and 1.7% in 2020. Meanwhile, inflation is expected to be 1.4% in 2018 and 2019, before rising to 1.7% in 2020. On the face of it, these figure are EUR-friendly, but would come on the back of a general improvement in global demand.

As such, we still believe that, whilst the recovery in the Eurozone economy does justify much of the EUR's appreciation, it has now been priced in, and it may require better Eurozone data, or sluggish growth elsewhere, to pull the EUR even higher.

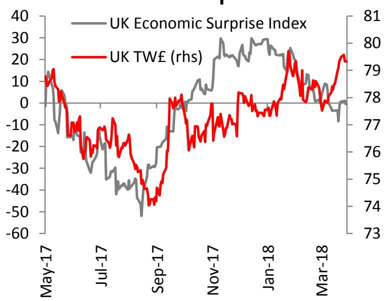
The risk backdrop should continue to offer EUR/USD some lingering support, but even this may start to falter. The currency took the Italian election result in its stride, with the pair more focused on the adverse impact of US politics on the USD, amid President Trump's removal of some members of his team and growing protectionist rhetoric. That said, planned talks with North Korea may have made the USD less vulnerable to risk shocks. A firmer, or even just more stable, USD over the coming month, helped by Fed rate hikes, would also curtail EUR gains.

In addition, all this comes at a time when the market is still extremely long the EUR. The IMM non-commercial positioning data show that the net long EUR/USD position is back close to its all-time high, and remains two standard deviations above its long-term average, implying it is still stretched and vulnerable to a EUR-negative reversal of these trades.

GBP – More to come

Sterling remains relatively firm, holding on to a lot of the gains made over the last few months. However, we still believe that the Pound should remain vulnerable. We do not think Brexit uncertainty will disappear despite an agreement on 'transition' being reached. Economic data have started to surprise to the downside and we do not think that the MPC should hike rates in the coming months.

Chart 70: Trade-weighted Sterling and UK economic data surprise index



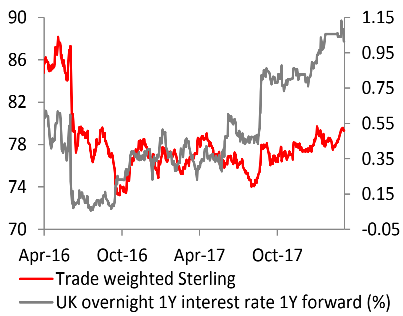
Source: Citi, Bloomberg, Santander

The MPC kept interest rates unchanged in March. The market is pricing in a 70% probability that the BoE will hike rates at its next meeting, on 10 May. We still believe that the Bank should keep rates on hold through to 2019. If it becomes clear that the Bank is edging away from a May move, the Pound should soften across the board over the next month, but we estimate that GBP/USD, GBP/JPY and GBP/CHF may be most vulnerable to weakening.

Moreover, recall that the MPC outlook assumes a 'smooth' Brexit. Even now that the UK and EU have agreed a transition agreement, uncertainty still surrounds the process. Remember that 'official' analysis 'released' in February forecast that the UK economy would be smaller under all the off-the-peg Brexit scenarios. For now, the FX market appears to be driven by short-term positives surrounding the Brexit process, such as the transition agreement, and is focusing less on the possible longer-term consequences.

The Pound's more relaxed approach to Brexit has been facilitated by the fact that the UK economy has fared better than expected since the June 2016 referendum. However, economic data have tended to disappoint in 2018. Further, the UK is still expected to underperform both the US and the EU. UK growth is expected to be around 1.4% in 2018, but 2.7% in the US, and 2.4% in the Eurozone.

Chart 71: Sterling remains supported by near-term rate hike expectations, but what if that rate hike does not materialize?



Source: Bloomberg, Santander.

Consequently, we still focus on two reasons for the Pound's resilience over the last few months. First, it was oversold following the EU referendum in June 2016, and has now reversed some of that decline. Second, what UK-focused commentators describe as Sterling "strength" has, in fact, primarily been USD weakness.

On the first point, we have often noted how much the Pound has diverged from its historical link with normally good fundamental indicators, such as IP and unemployment. The implication being that, since June 2016, Brexit panic overrode the economic data. However, with the data now disappointing expectations, we find it unlikely that the market may want to pull the Pound much higher.

In addition, a large part of the GBP/USD gains have been driven by USD weakness. Whilst the USD continues to be dogged by worries over trade protectionism and lower risk appetite, we continue to believe that the robust US economy and Fed rate hikes will support the currency during the remainder of 2018. This may not imply massive USD buying, but it should ensure that GBP/USD can no longer rely on the USD to pull it higher.

Table 7: G10 FX forecasts

	Q2 18	Q3 18	Q4 18	Q1 19	Q2 19	Q3 19
EUR-USD	1.22	1.24	1.26	1.22	1.24	1.27
GBP-USD	1.36	1.34	1.32	1.32	1.33	1.35
GBP-EUR	1.11	1.08	1.05	1.08	1.07	1.06
EUR-GBP	0.90	0.93	0.95	0.92	0.93	0.94
USD-JPY	116	117	118	120	122	120
EUR-JPY	142	145	149	146	151	152
USD-CNY	6.60	6.65	6.70	6.80	6.70	6.70
EUR-CHF	1.17	1.18	1.20	1.22	1.23	1.24
USD-CHF	0.96	0.95	0.95	1.00	0.99	0.98
EUR-SEK	9.5	9.3	9.0	8.8	8.6	8.6
EUR-NOK	9.5	9.4	9.3	9.1	9.0	8.8
USD-CAD	1.24	1.24	1.22	1.22	1.20	1.20
AUD-USD	0.76	0.76	0.77	0.79	0.80	0.79
NZD-USD	0.70	0.71	0.72	0.74	0.76	0.75

Source: Bloomberg, Santander

Euro interest rate forecasts

Government Bond yield Forecasts

Bunds	Current	2Q18	3Q18	4Q18	1Q19	2Q19
ECB Refi	**0.00**	0.00	0.00	**0.00**	0.00	0.10
ECB Depo	**-0.40**	-0.40	-0.40	**-0.40**	-0.40	-0.40
3m	**-0.74**	-0.75	-0.70	**-0.60**	-0.55	-0.35
2y	**-0.59**	-0.45	-0.30	**-0.15**	-0.10	0.10
5y	**-0.09**	0.05	0.20	**0.35**	0.50	0.65
10y	**0.51**	0.65	0.80	**0.95**	1.15	1.30
30y	**1.17**	1.30	1.40	**1.50**	1.70	1.85

Swap rate forecasts

€ swaps	Current	2Q18	3Q18	4Q18	1Q19	2Q19
ECB Refi	**0.00**	0.00	0.00	**0.00**	0.00	0.10
ECB Depo	**-0.40**	-0.40	-0.40	**-0.40**	-0.40	-0.40
3m	**-0.33**	-0.33	-0.33	**-0.33**	-0.27	-0.14
2y	**-0.15**	-0.05	0.10	**0.20**	0.25	0.40
5y	**0.37**	0.50	0.60	**0.75**	0.85	1.00
10y	**0.96**	1.10	1.20	**1.35**	1.50	1.65
30y	**1.49**	1.55	1.65	**1.75**	1.95	2.10

US interest rate forecasts

Government Bond yield Forecasts

USTs	Current	2Q18	3Q18	4Q18	1Q19	2Q19
FOMC (mid)	**1.625**	1.875	1.875	**2.125**	2.375	2.625
3m	**1.70**	1.90	2.00	**2.25**	2.50	2.75
2y	**2.29**	2.40	2.55	**2.85**	3.10	3.35
5y	**2.62**	2.75	2.90	**3.15**	3.40	3.60
10y	**2.82**	2.90	3.00	**3.25**	3.45	3.65
30y	**3.06**	3.10	3.20	**3.40**	3.60	3.75

Swap rate forecasts

$ swaps	Current	2Q18	3Q18	4Q18	1Q19	2Q19
FOMC (mid)	**1.625**	1.875	1.875	**2.125**	2.375	2.625
3m	**2.33**	2.40	2.10	**2.55**	2.70	2.85
2y	**2.61**	2.55	2.60	**2.85**	3.10	3.35
5y	**2.77**	2.75	2.85	**3.10**	3.30	3.50
10y	**2.85**	2.85	2.90	**3.15**	3.35	3.55
30y	**2.91**	2.90	2.95	**3.15**	3.35	3.50

UK Interest rate forecasts

Government Bond yield Forecasts

Gilts	Current	2Q18	3Q18	4Q18	1Q19	2Q19
MPC	**0.50**	0.50	0.50	**0.50**	0.50	0.50
3m	**0.49**	0.40	0.40	**0.45**	0.45	0.50
2y	**0.87**	0.65	0.40	**0.50**	0.55	0.60
5y	**1.16**	1.00	0.80	**1.00**	1.20	1.30
10y	**1.41**	1.60	1.40	**1.60**	1.70	1.80
30y	**1.80**	1.90	1.90	**2.10**	2.20	2.40

Swap rate forecasts

£ swaps	Current	2Q18	3Q18	4Q18	1Q19	2Q19
MPC	**0.50**	0.50	0.50	**0.50**	0.50	0.50
3m	**0.75**	0.60	0.55	**0.55**	0.55	0.55
2y	**1.15**	0.95	0.80	**0.80**	0.95	1.00
5y	**1.40**	1.25	1.15	**1.30**	1.50	1.50
10y	**1.56**	1.70	1.50	**1.70**	1.80	1.80
30y	**1.59**	1.70	1.60	**1.70**	1.80	2.05

FX forecasts

	Current	2Q18	3Q18	4Q18	1Q19	2Q19
EUR-USD	**1.224**	1.22	1.24	**1.26**	1.22	1.24
EUR-GBP	**0.874**	0.90	0.93	**0.95**	0.92	0.93
GBP-USD	**1.200**	1.36	1.34	**1.32**	1.32	1.33
USD-JPY	**107.3**	116.0	117	**118**	120	122
EUR-JPY	**131.4**	141.5	145	**149**	146.4	151.3

	Current	2Q18	3Q18	4Q18	1Q19	2Q19
NZD-USD	**0.725**	0.70	0.71	**0.72**	0.74	0.76
USD-CAD	**1.278**	1.24	1.24	**1.22**	1.22	1.20
AUD-USD	**0.769**	0.76	0.76	**0.77**	0.79	0.80
EUR-CHF	**1.178**	1.17	1.18	**1.20**	1.22	1.23
EUR-SEK	**10.30**	9.5	9.3	**9.0**	8.8	8.6
EUR-NOK	**9.58**	9.6	9.4	**9.3**	9.1	9.0

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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) 33114 80133
José María Fernández	Rates Strategy	josemariafernandezl@gruposantander.com	(+34) 91 257-2244
Edgar da Silva	Rates Strategy	efda@gruposantander.com	(+34) 91 257-2244
Stuart Green	UK Economics	stuart.green@santandergcb.com	(+44) 33114 80239
Adam Dent	UK Rates Strategy	adam.dent@santandergcb.com	(+44) 33114 80240
Stuart Bennett	G10 FX Strategy	stuart.bennett@santandergcb.com	(+44) 33114 80134
Michael Flisher	G10 FX Strategy	michael.flisher@santandergcb.com	(+44) 33114 80232
Antonio Espasa	Chief Economist	aespasa@gruposantander.com	(+34) 91 289 3313
Laura Velasco	G10 Economics	laura.velasco@gruposantander.com	(+34) 91 175 2289
Beatriz Tejero García	G10 Economics	beatriz.tejero@gruposantander.com	(+34) 91 257 2176

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

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