6 September 2018, 13:00 CET

Interest & Exchange

Tightening, Fast and Slow

Global Strategy: We believe the decline in growth expectations in most Euro countries is probably behind. We therefore think the pace of normalization of ECB official rates, once it starts a year from now, is a bit too slow. But given all the present uncertainties, there is not much incentive for the ECB to change its current dovish tone for the time being.

US Macro: 2Q18 GDP figures showed a significant acceleration of the US economy after the modest growth posted in 1Q18. The fiscal package brought in by the government seems to be already having a significant impact on economic growth. Internal demand is doing quite well, driven by both investment and private consumption although uncertainty persists as regards net exports. We maintain our forecast of 2.8% GDP growth for 2018, with risks skewed to the upside.

US Rates: The Fed remains on course to hike at the 25-26 September FOMC meeting and is likely to do so again in December. However, the market remains sceptical when it comes to the probability of the current pace of quarterly hikes being maintained for too long. Additionally, the number of positive surprises on the macro front is waning, while existing uncertainties are unlikely to be cleared up imminently. Therefore, we stick to carry-efficient shorts (pay the belly in 2s7s10s).

EUR Macro: Weaker Spanish 2Q18 GDP made investors more pessimistic about the sustainability of the economic cycle. We believe that this pessimism is unjustified and expect 2H18 GDP to confirm that 2Q was a one-off. Fundamentals are still strong and salaries per employee seem to be starting to pick up.

EUR Rates: EUR rates have traded sideways due to loose policy and risk-off sentiment. Policy normalisation will continue in 2019, however, so market rates should rise slowly. Policy risk in Italy is the key issue, with budget negotiations in September and October. Implied credit risk seems high but volatility makes BTPs less attractive. Given the more solid data and much lower policy risk, Spanish risk premia seem a better position, right now.

GBP Macro: Despite constituting a 'clear and present danger' to the UK outlook since the very beginning of the Article 50 negotiations, the prospect of a 'no-deal' outcome to the Brexit process, and the likely implications for the UK economy, have come into much sharper focus in recent weeks. With the Northern Ireland backstop likely to remain a key stumbling block to significant progress within EU-UK negotiations in the coming weeks, we believe that such anxieties could well persist through the final months of 2018.

GBP Rates: UK rates have also gone nowhere over the summer, and we expect indecisive market conditions to continue for several weeks more. We no longer see them as likely to achieve a (mild) sell-off before year-end, and outperform rates elsewhere, as Brexit/domestic political uncertainties persist and slower economic growth becomes established. ASW may look very wide, but we believe they are generally sustainable under these conditions, especially against Sonia.

G-10 FX: The USD remains firm amid positive fundamentals and low risk appetite but rate hikes may be priced into the currency, and trade tensions could weigh on US activity and the dollar. The EUR has softened against the backdrop of reduced risk appetite, but there is scope for it to recover, if risk stabilises and the focus shifts to the firm Eurozone outlook. The pound remains vulnerable. The BoE hiked rates in August, but does not seem in a rush to tighten again. UK economic data seem to have improved, but Brexit uncertainty should cap gains.

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

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Santander Corporate & Investment Banking

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

	USD	EUR	GBP
Economic Outlook	We have revised our GDP estimates for 2018 to 2.8% YoY (from 2.5%) and to 2.7% in 2019 (vs 2.6%) after including the effect of the fiscal reform. We expect a higher fiscal deficit and worse c/a balance	We have reduced our GDP estimate for 2018 to 2.3% (from 2.4%.), while leaving 2019 at 2.2%. Growth in 1Q18 was lower than-expected but fundamentals support 2.0%+ growth in 2018-19 with internal demand as the main driver.	We expect UK GDP growth of c.1.2% in 2018E, with investment constrained by ongoing Brexit uncertainty. Falling inflation should flatter real consumption growth in 2H18.
Monetary Policy / Front-End	The Fed is increasingly likely to hike rates every quarter this year, but we believe it won't be able to raise rates as much as expected by the dot plot in 2019.	The ECB will continue buying bonds until Dec'18 but the first rate hike will not take place until Sep-2019. And once it starts, it might be faster than priced in by the market	We expect Bank Rate to remain unchanged at 0.75% until at least the end of 2019, with the growth and inflation data, plus rising Brexit risks, likely to frustrate the MPC's tightening bias.
Rates / Duration	The monetary policy normalisation, healthy macro environment and potential changes in the supply/demand equilibrium should weigh on USTs all along the curve.	ECB restraint, moderate data and risk-off sentiment keep the bearish trend very flat. The long-term outlook remains for higher rates, though.	Rates should remain range-bound, although potentially more volatile, while the Brexit outcome is so uncertain.
Curve / Slope	We remain bearish on the front end (pay 2y2y) but continue to prefer carry-efficient shorts in the belly (pay the belly in 2s5s30s).	Overall steepness has been highly directional. Relative to short-term stats, the longer rates look a bit flat but, if rates rise, the curve will flatten further.	Short and ultra-long gilts look relatively cheap (<7y and >35y), and 10y's liquidity premium may start to fade after the summer lull in volumes.
Spreads	Gradually unwinding SOMA reinvestments pose a risk for USTs. We like swap spread wideners (bearish USTs), especially at the ultra-long end.	Spread volatility is driven by Italy and risk elsewhere but Spanish fundamentals are strong. The budget season in Italy is fraught with risk, also for ratings.	Brexit and EM concerns justify wide gilt ASW, although the long end's may have gone too far. 7y looks anomalously tight, and could catch up if anxieties mount further.
Volatility	Long end gamma and front-end vega look cheap, both compared to recent ranges and delivered vols. The top-left corner does not look rich compared to delivered vols.	The explicit commitment of the ECB to a low-volatility rates environment is difficult to overcome by implied vols, and realised vols have also been falling.	Implied volatilities in general remain remarkably sedate. Post-Brexit expiry, short tenor vols look reasonable but slightly under-price tail risks.
Inflation / Break-evens	Breakevens have recovered slightly but, in our view, still fall short of pricing in the YtD increase in core CPI. We see a buying opportunity there, especially at the front end.	Flash HICP experienced a small deceleration in the y/y rate. Given current fundamentals, we expect no break of the tight 2018 range in market-traded inflation (less than 15bp for 10y ILS).	Petrol prices have paused the fall in CPI, but we still expect a move to the 2% target by year-end. Wage growth is still pivotal and underwhelming. 5s10s breakevens may flatten further.
FX	The USD has slipped recently. Political and trade concerns may still impact. But, the mix of a strong economy and further Fed rate hikes in 2018E should provide some support going forward.	EUR/USD has perked up since mid-August. Soft economic data and EU-US rate spreads may also weigh, but a less loose ECB monetary policy from Q4-18 should be supportive.	Sterling is off of its lows as the USD has slipped. But, the Pound remains vulnerable to slower GDP, CPI and political/Brexit uncertainty. We do not expect the BoE to hike rates until 2020.

Source: Santander Economics, Rates and FX Strategy Research. For a full list of contributors, please see contact details on page 30.

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 1.4% Jul-28 vs. Bund 0.25% Aug-2028** at +106bp. Target +70bp.	**1) Buy UKT 24s vs. 23s&25s.** Current level = 3bp. Target = 1bp. Stop = 5bp. **2) UKT 30s40s flattener.** Current level = -11bp, Target = -13bp. Stop = -9bp.
Rates	**1) Pay the belly in 2s7s10s** Entry = 2bp. Target = 6bp. SL= 0bp **2) Pay 2y2y in USD swaps** Entry level = 2.90%.Target = 3.30%. Stop loss = 2.70%	**1) EUR 5s30s 'bearish' flattener** at -120bp. Target 106bp **2) Pay 10y Euribor fixed, receive 10y ILS** at -0.67%. Target -0.45%	**Receive 6m Sonia OIS.** Entry level = 0.70%.Target = 0.60%. Stop loss = 0.73%
FX	**Buy EUR/USD** at 1.16 target= 1.19, with a stop loss at 1.1450	**Sell EUR/SEK** original entry (Apr-18) at 10.54. Target = 9.50. SL = 11.06.	**Sell GBP/CAD** at 1.70, target = 1.65, with a stop loss at 1.7280

Global Strategy: Transatlantic Forward Guidance Divergence

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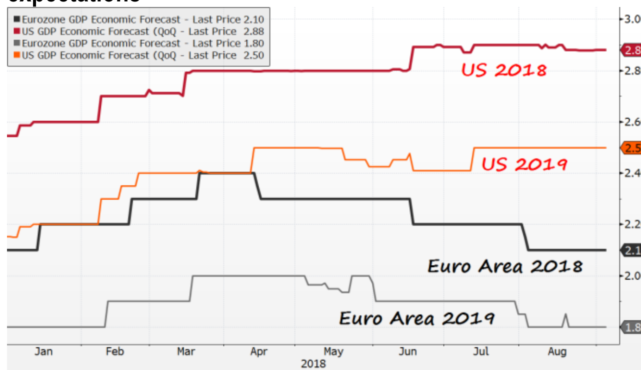
- **We believe the decline in growth expectations in most Euro countries is probably behind. We therefore think the pace of normalization of ECB official rates discounted by the market - once it starts a year from now - is a bit too slow. But given all the present uncertainties, there is not much incentive for the ECB to change its current dovish tone at this stage.**

Diverging cycles; how long can it last?

There have not been many relevant changes regarding the outlook for advanced economies in recent weeks, but we believe the sizeable divergence in growth expectations revisions between the US and the Euro area is about to end. While in the last couple of months the expectations for US growth have been revised clearly upwards for both 2018 and 2019 (Chart 1), it has been the opposite for most Euro countries, with growth expectations haven't declined in this period by 0.5% in Germany (to 2.0%), and by 0.3% in Italy and France (to 1.8% and 1.2% respectively, Chart 2).

That said (see Economics section), although we think the US economy can perfectly grow at the levels the consensus is currently expecting, helped to a large extent by the ongoing fiscal expansion, we are more optimistic than the market for the Euro Area economy for this year and the next.

Chart 1: Euro area vs. US GDP; 2018 and 2019 consensus expectations



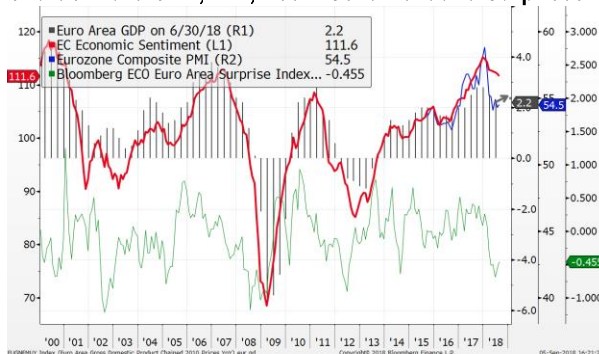
Source: Santander, Bloomberg

Chart 2: Euro countries' 2017-19 GDP consensus

Source: Santander, Bloomberg

Despite this decline in growth expectations, most Euro Confidence Surveys remain at fairly high levels while the Economic Surprise Indices have stopped deteriorating (Chart 3). This recent macro weakness is one of the reasons why the market might have become too negative with the prospects of monetary normalization in the Euro Area. With the ECB having unveiled last June most of its conventional and non-conventional measures for the next twelve months (see Exhibit 1), **the focus has shifted to the start and pace of monetary normalization in the Euro area from September 2019**.

Chart 3: Euro GDP, PMI, Econ. Sentiment and Surprises



Source: Bloomberg, Santander

Exhibit 1: ECB June Statement on future Conventional and Non-Conventional Monetary Policy. No surprises for a while

-The ECB will continue their asset purchases at the current pace of €30bn/mth until the end of Sep'18, then €15bn until the end of 2018, when net purchases will end.

- The GC intends to maintain its policy of reinvesting the principal payments from APP maturing securities for an extended period of time

- The ECB expects interest rates to remain at their present levels at least through the Summer of 2019 and in any case for as long as necessary

Source: ECB, Santander

Table 1: ECB Depo Rate forwards & Market-implied Probabilities

ECB Meeting date	fwd Eonia	Probability of 10bp changes			
		0	1	2	3
Sep 13, 2018	-0.36%	100%	-	-	-
Oct 25, 2018	-0.36%	100%	-	-	-
Dec 13, 2018	-0.35%	90%	10%	-	-
Jan 24, 2019	-0.35%	90%	10%	-	-
Mar 07, 2019	-0.35%	90%	10%	-	-
Apr 10, 2019	-0.35%	90%	10%	-	-
Jun 06, 2019	-0.34%	80%	20%	-	-
Jul 25, 2019	-0.34%	80%	20%	-	-
Sep 12, 2019	-0.30%	40%	60%	-	-
Oct 24, 2019	-0.27%	10%	90%	-	-
Dec 12, 2019	-0.23%	-	70%	30%	-
Jan 23, 2020	-0.21%	-	50%	50%	-
Mar 05, 2020	-0.16%	-	0%	100%	-
Apr 08, 2020	-0.15%	-	-	90%	10%
Jun 04, 2020	-0.13%	-	-	70%	30%
Jul 23, 2020	-0.08%	-	-	20%	80%

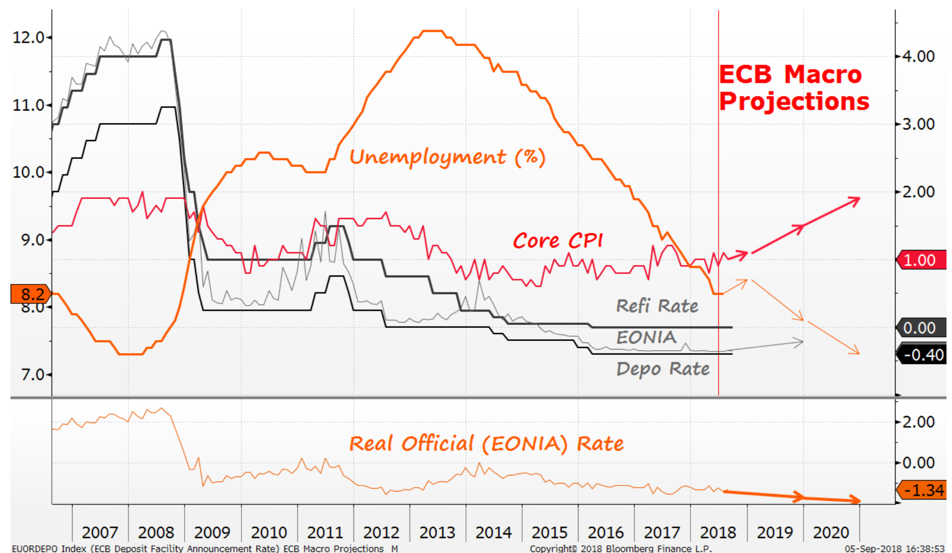
Source: Bloomberg, Santander

As seen in Table 1, the market is currently expecting the first ECB hike around September 2019 (+10bp in the Deposit Facility Rate, 60% discounted), but it does not expect this move to be followed by another similar instalment until March 2020, with the Depo rate getting to zero only by December 2020. Similarly, the market is discounting three-month Euribor rates, currently at -31.9bp, will not become positive until the Spring of 2020.

As mentioned above, we are more optimistic than the consensus about the Euro economy in coming quarters and we think that not only the health of this economy will allow to start that normalization in one years' time, but we think the pace is likely be a bit more aggressive than currently discounted. But more important, the ECB is also fairly optimistic on the Euro economy; despite the 0.3% downward revision to this year's Euro Area GDP growth in its latest Staff Macro Projections, the ECB is expecting Core inflation at 1.5% in late 2019 and 1.9% in 2020, with growth averaging 2.0% in the 2018-2019 period.

Furthermore, the ECB is expecting the Euro Area unemployment rate to fall to 7.8% by the end of 2019, with a further 0.5% decline in this measure in 2020, levels not seen since before the crisis (Chart 4). And that additional tightening in the labour market could end up putting some upward pressure on wages.

Chart 4: Euro Area Core Inflation & Unemployment Rates + ECB Projections compared to Official Interest Rates and Real EONIA Rates + forwards



Source: Bloomberg, Santander

It is also worth keeping in mind that the last time the Euro Area unemployment rate was at such a low level (7.23%, in March 2008, has been this metric's all-time low), ECB official rates were at 4% in nominal terms, and above 2% in real terms. But, if current forwards prove to be true in coming years, short term (EONIA) real rates will become even more negative in 2019 and 2020 than they are today, going below -1.8%, with an economy growing at a healthy pace, inflation around its target and the labour market is at its tightest level in recent history. We believe this will be too stimulative, and official rates should at least increase at the same pace than underlying inflation in this area (to avoid further declines in Euro real rates).

We therefore think current market pricing regarding the pace of normalization of the ECB monetary – once it starts in September 2019 - is not consistent with the own Central Bank (healthy) macro expectations for coming quarters. It seems to us the opposite approach than the Federal Reserve's 'aggressive' dot plot, with its members' expecting seven additional rate hikes between now and December 2020 (according to the median FFR).

Investors could wonder then why the ECB and its president seem fairly comfortable with current market pricing (see margin).

Mario Draghi on the path of future official rate increases

"The path of short-term rates implicit in today's money market term structure broadly reflects our principles" (Sintra, 19 June)

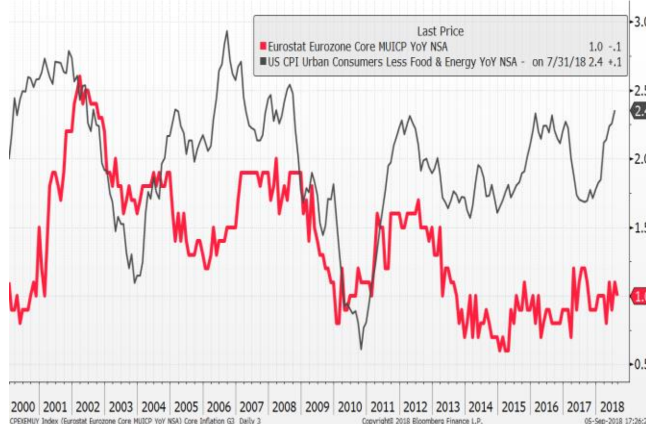
"This enhanced forward guidance has been very effective …in aligning expectations of the future rate path with our anticipations … we don't see the need to modify or to add new language"
(ECB meeting July 2018)

Our take in this regard is that, especially after some relatively recent experiences, the ECB feels there is no incentive in 'scaring' markets about this eventual normalization. At least at this stage, bearing also in mind this potential monetary normalization will take place in the middle of a deep change of guard at the institution, with several key jobs at the bank, including its presidency, about to expire between May and December 2019.

We believe some of the main reasons for the ECB to remain relatively dovish in its forward guidance are:

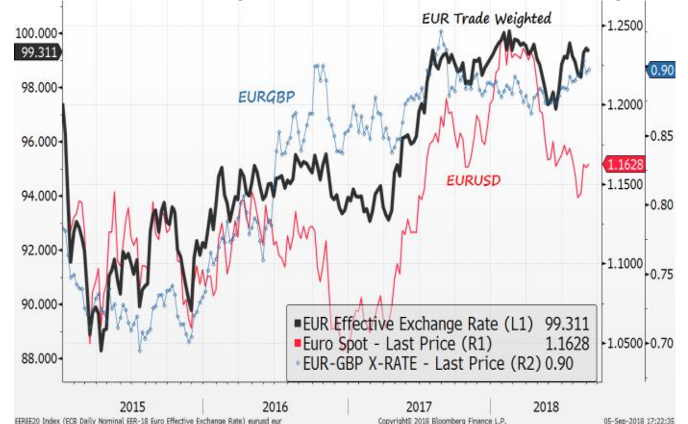
- The above-mentioned downward growth revisions, both by the consensus and the own ECB (although only for 2018).
- Euro Core inflation, as despite all this stimulus, it is still at 1%, and doesn't seem able to leave behind the 0.7%-1.2% range is has been at for the last three and a half years, rising some potential hysteresis fears (Chart 5).
- Political uncertainty as, although the ECB is (should be) agnostic to it, in this environment, it could lead to potential 'biased' misinterpretations in some countries in a complicated moment for some countries.
- Although it could seem otherwise, given its recent decline vs the USD, the EUR exchange rate is not weak as would seem by looking only at this pair. As seen in Chart 6, helped by its strength vs GBP and most EM currencies, in Nominal Effective terms, the EUR is close to its recent highs. And we know this currency tends to react quickly to monetary tightening comments.

Chart 5: US and Euro Core Inflation



Source: Bloomberg, Santander 110

Chart 6: Euro exchange rate; vs USD, GBP and Trade-Weighted



Source: Bloomberg, Santander 431

Accordingly, despite the extraordinary level of accommodation in the Euro Area (ECB's balance sheet at 40% of GDP, €1.9trn excess liquidity, five-year German bonds at -20bp, ECB Deposit rates at -40bp, etc) and the slow-but-continuous economic and credit flow recovery in recent quarters, the ECB is unlikely to deviate at this stage significantly from its current dovish 'enhanced forward guidance' mantra and therefore, we do not expect much action in the front-end of the Euro curve in the short run. Even more so given also all the international uncertainties, from Brexit, to US mid-term elections, tariff war, Brexit or the EM crisis.

But if we are correct with our macro and financial outlook, we think the ECB will be able to remove its significant monetary easing at a slightly faster pace than currently implied by the market, helped also by a slightly looser fiscal environment.

US Economic Outlook

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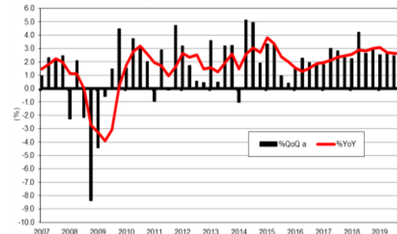
2Q18 GDP figures showed a significant acceleration of the US economy after the modest growth posted in 1Q18. The fiscal package brought in by the government seems to be already having a significant impact on economic growth. Internal demand is doing quite well, driven by both investment and private consumption. Uncertainty persists as regards net exports, given the US administration's ongoing trade negotiations. We maintain our forecast of 2.8% GDP growth for 2018E, with risks skewed to the upside.

Chart 7: GDP, 2007-19E

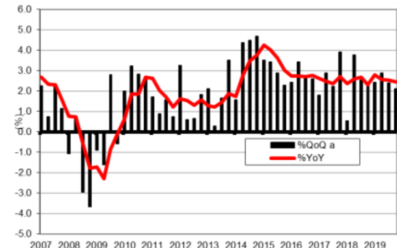


Source: Datastream and Santander.

Chart 8: GDP vs. private domestic final sales, 2007-19E

Source: Datastream and Santander.

Chart 9: GDP-Private consumption, 2007-19E



Source: Datastream and Santander.

The US economy accelerated in 2Q18

The second release of 2Q18 GDP suggested that the US economy was accelerating going into 2H18E, which was subsequently reinforced by the recently published numbers for 3Q18E. Regarding 2Q18 GDP figures, the preliminary release evidenced slightly better than expected figures.

The second release of GDP numbers showed a growth rate of 4.2% QoQa versus an advance print of 4.1% QoQa in 2Q18 and expectations that pointed to a downward revision to 4.0% QoQa. The economy has therefore maintained the acceleration trend shown in the advance release, with the annual growth rate up to 2.9% in 2Q18 from 2.6% in 1Q18 and 2.2% in 2017. The fiscal package is certainly pushing the economy upwards in the short run and this positive effect should persist in the coming quarters.

We maintain our GDP estimate of 2.8% for 2018E and 2.7% in 2019E, with the risks being more on the upside in both years.

Internal demand continues to perform well, with private consumption spiking in 2Q18…

The breakdown shows that internal demand notched up a great performance in the quarter, with net exports also helping substantially. Final sales grew by 5.5% QoQa (the strongest growth rate since 2003); domestic final sales rose by 4.0% QoQa, since the positive contribution of net exports (+1.3pp to the QoQa in 2Q18) was offset by the negative inventories figure (-1.2pp contribution to the QoQa in 2Q18 GDP). Finally, private domestic final sales climbed 4.3% QoQa.

Personal consumption rebounded in the quarter (3.8% QoQa in 2Q18 from 0.5% QoQa in 1Q18, although the advance release showed an increase of 4.0% QoQa), mainly as a result of the poor performance in the previous quarter and the extra money in households' pockets thanks to the fiscal reform. Durable goods jumped (8.6% in 2Q18 from -2.0% in 1Q18), with non-durables also performing well (3.7% in 2Q18 from 0.1% in 1Q18), as did services (3.1% in 2Q18 from 1.0% in 1Q18). Moreover, prices seem to be reacting positively to the upside, with the PCE deflator up by 2.2% YoY in 2Q18 and the PCE core deflator growing by 1.9% YoY in 2Q18 (the highest annual growth rate since 2Q12).

The numbers released for 3Q18E point to another good quarter for private consumption. July retail sales showed an increase of 0.5% MoM, with core retail sales up by 0.6% MoM (0.2% MoM in June). Personal consumption for the same month ticked up by 0.4% MoM (0.4% MoM in June), with real consumption rising 0.2% MoM (0.3% MoM in June).

On the income side, personal income posted an increase of 0.3% MoM in July, with gross disposable income up by 0.3% MoM. Due to the recent revision of the numbers, growth rates and levels of income, consumption and savings have changed. In this regard, the current level of savings (6.7% of GDI) is higher than previously estimated. In our view, this puts households in a much stronger financial position and clearly reduces the risk of a negative outcome in consumption because of a poor performance of income, savings and wealth.

With employment doing quite well (224k average in May-July) and the fiscal package still having a positive impact on income in the near term, we would expect private consumption to remain healthy over the remainder of the year. Moreover, hourly wages could keep accelerating (2.7% YoY in May-July), which in the end would add even more to households' accounts.

Business investments are finally accelerating, which could have a very positive impact on productivity…

On the investment side, the numbers were positive in general terms, particularly those related to business investment, while residential performed poorly, as in the previous quarter. Non-residential fixed investments rose by 8.5% QoQa in 2Q18 (7.3% QoQa previously estimated) from 11.5% QoQa in 1Q18, pushing the annual growth rate up to 7.0% from 6.7% previously. The breakdown shows strong numbers in structures (13.2% QoQa from 13.9% in 1Q18) and equipment (4.4% QoQa, up from the previous estimate of 3.9% QoQa) and a significant increase in intellectual property investments (11.2% QoQa from 14.1% in 1Q18). Residential investments, however, posted another decline (-1.6% QoQa) in 2Q18 after the -3.4% QoQ reported in 1Q18. Moreover, recent data suggest that the sector remains relatively weak.

Leading figures released for July point to another good quarter for business investments. Although capital goods orders (-5.0% MoM) and shipments (-3.8% MoM) were relatively weak in July, orders and shipments excluding defence and aircraft were again solid: core orders rose by 1.4% MoM and core shipments increased by 0.9% MoM.

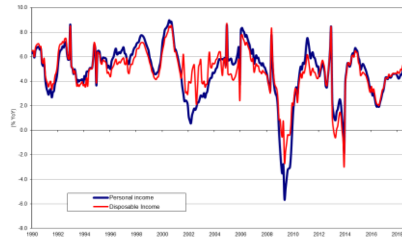
Interesting messages from both inventories and net exports…

Both the external sector and inventories stood out in 2Q18. The change in inventories came in at $-26.9bn from $-28bn previously estimated ($30bn in 1Q18), which implied a negative contribution to GDP growth in the quarter of -1.2pp. In our view, this decline in inventories highlights the current imbalance between supply and demand in the economy, which should imply an acceleration of business activity in 2H18E. On the other hand, net exports added 1.3pp to GDP growth in the quarter, thanks to a decline of 0.4% QoQa in imports (+0.5% QoQa previously estimated) and an acceleration of exports (9.1% QoQa). We expect exports to keep on growing in 2H18E (4.1% in 2018E), although trade tensions would evidently be a risk, while imports should also go up (5.5% in 2018E), given companies' need to accelerate production to satisfy the current levels of final demand. Finally, public expenditure has also benefited from the fiscal package, showing an increase of 2.3% QoQa in the quarter (1.5% QoQa in 1Q18).

Still upside risk to 2H18E GDP numbers…

The story for GDP growth during the rest of the year is likely to remain positive. The fiscal package should keep on supporting GDP growth, while the imbalance between supply and demand in the economy (resulting in a sharp decline in inventories) is likely to push activity growth rates higher. Annual growth could be c.2.8%, which is in line with our estimates. We are not concerned about the performance of the US economy in coming quarters. The main risk would be a sharper than expected increase in inflation going forward, which could push the Fed to accelerate the removal of the current expansionary monetary policy.

Chart 10: Personal Income and gross disposable income, 1990-July18

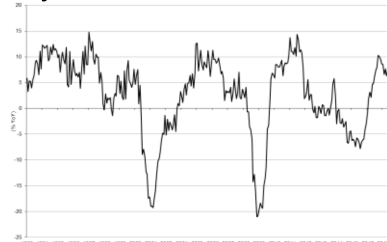


Source: Datastream and Santander.

Chart 11: Savings rate vs. personal income taxes, 1990-July18

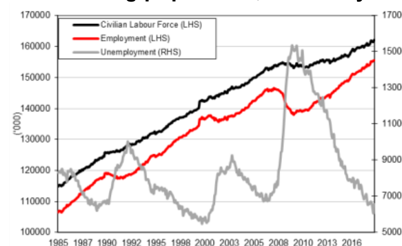
Source: Datastream and Santander.

Chart 12: Capital goods shipments excluding defence and aircraft, 1993-July18



Source: Datastream and Santander.

Chart 13: Employment, unemployment and working population, 1985-July18



Source: Datastream and Santander.

US Rates Strategy: Becalmed

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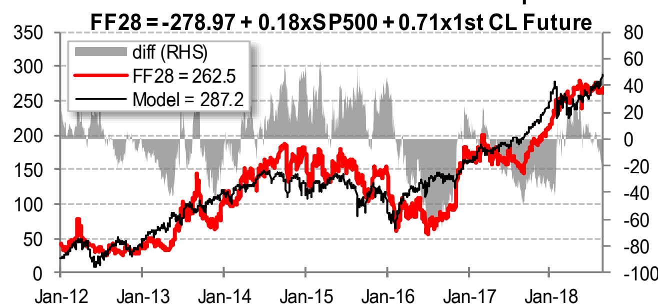
- **The Fed remains on course to hike at the 25-26 September FOMC meeting and is likely to do so again in December, despite the ongoing concerns about global trade and EM jitters. However, the market remains sceptical when it comes to the probability of the current pace of quarterly hikes being maintained for too long. That is likely to continue even if the updated dot chart to be published in two weeks' time remains, as expected, more hawkish than the market.**
- **The number of positive surprises on the macro front is waning (as the consensus is getting used to the already strong macro figures), while existing uncertainties are unlikely to be cleared up imminently. As a result, it seems that it would take a sudden change in the macro picture or the Fed's language to bring about sizable market changes in the next few weeks.**

The impetus that took 10y rates back to the 3% level by the end of July, coinciding with the publication of the previous edition of this report, proved short-lived. Back then, we felt reluctant to read that price action as the beginning of an imminent bearish trend. And while we continue to expect higher rates in the US in the quarters to come, we find no clear signs to believe in a relevant upward correction in yields in the next few weeks.

It is true that the Fed remains on course to hike at the 25-26 September FOMC meeting and is likely to do so again in December, despite the ongoing concerns about global trade and EM jitters. However, the market remains sceptical when it comes to the probability of the current pace of quarterly hikes being maintained for too long. We think that this situation is likely to continue even if the updated dot chart to be published in two weeks' time remains, as expected, more hawkish than the market.

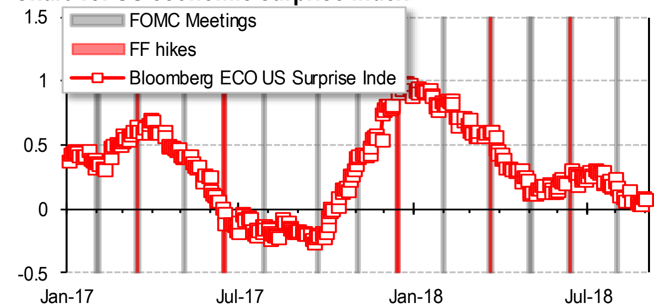
Even though FF futures currently remain well below the median of the dots depicted in the FOMC dot chart for 2020, the FFZ0 looks quite consistent with the recent evolution of equity and oil prices in the US. As shown in Chart 14, the FF28 future (which currently corresponds to the FFZ0 contract) at around 2.65% looks perfectly consistent with the current highs in the S&P and oil prices back over $70/bbl, according to their historical correlation since January 2012. As long as this relationship persists, it would take equites and/or oil prices rallying further to put clear upward pressure on monetary policy expectations in the short run. Additionally, as shown in Chart 15, the number of positive surprises on the macro front is waning (as the consensus is getting used to the already strong macro figures), so we think that it would take a sudden change in the macro picture or the Fed's language to bring about sizable market changes in the next few weeks.

Chart 14: FF futures as a function of S&P and CL prices



Source: Bloomberg, Santander.

Chart 15: US economic surprise index



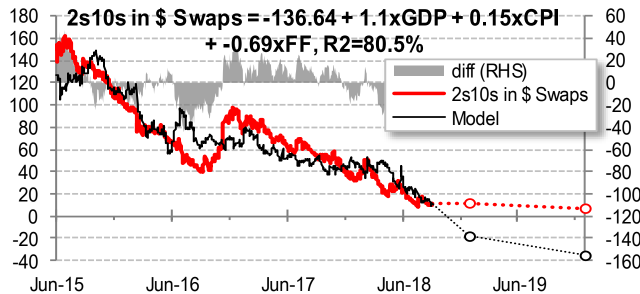
Source: Bloomberg, Santander.

The flattening might still continue (and the Fed knows it)

In the meantime, the US curve has continued to flatten and, as we have discussed in previous editions of this report, such a trend is likely to be maintained. The historical correlation between the 2s10s slope in USD swaps and the combination of macro (positive beta) and monetary policy (negative beta) expectations suggests that, unless the macro picture suddenly surprises by improving much faster than expected (which at current, strong levels looks unlikely), the gradual increase in FF rates will continue to flatten the US curve, even though it is already at historically low levels (see Chart 16).

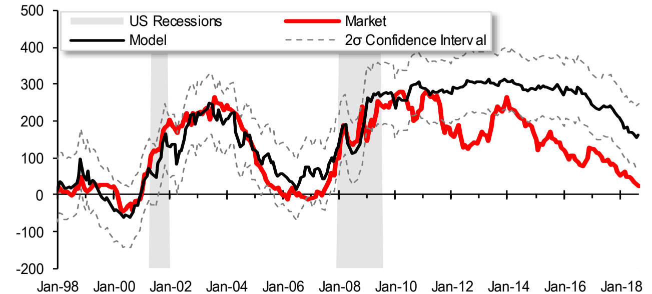
In this connection, we have already explained in previous editions of this report that the current slope is significantly flatter than it should be due to the reduction in risk premia driven by major central banks' asset purchases (see our 29 June I&E report) and therefore fears about current slope levels anticipating an imminent recession in the US should be taken with a pinch of salt. Note that the minutes to the August FOMC meeting revealed that the Fed had already discussed the possible implications of a flattening in the term structure of US rates and they also concluded that, in the current environment, "an inversion of the yield curve might not have the significance that the historical record would suggest" – suggesting that other indicators pointing to some kind of deceleration in activity or inflation would be more likely to stop the Fed from continuing with the gradual increase in official rates in the next few quarters.

Chart 16: 2s10s as a function of macro (GDP, CPI consensus) and monetary policy (FF futures) expectations



Source: Bloomberg, Santander.

Chart 17: 2s10s in USTs – with and without the estimated impact of asset purchases



Source: Bloomberg, Santander.

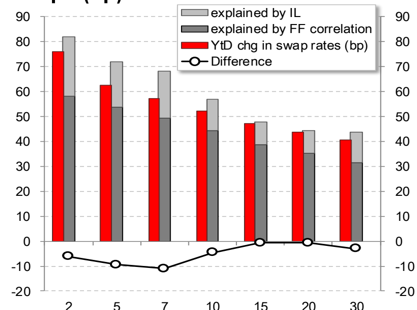
The 5-7y tenors look too low in the USD swap curve again

Therefore, we stick to our positioning through carry-efficient shorts as we like to have some exposure to a possible upward repricing in US rates, but we also acknowledge that the timing of such an event is uncertain.

As shown in Chart 18, we continue to identify the 7y tenor of the USD swap curve as too low compared with the recent performance of IL swaps and FF futures, and therefore we would now select that tenor for shorts.

Paying the belly in the 2s7s10s butterfly should capture the correction of this possible dislocation, while offering a quite attractive carry and roll-down:

Chart 18: Dislocations in USD swap rates compared to YtD changes in (beta-weighted) FF futures and in USD IL swaps (bp)



Source: Bloomberg, Santander.

Trade idea: Pay the belly in 2s7s10s USD swaps

Entry level = 2bp. Target = 6bp (June levels). Stop-loss = 0bp
3m carry = 2.7bp. 3m roll-down = 2.8bp

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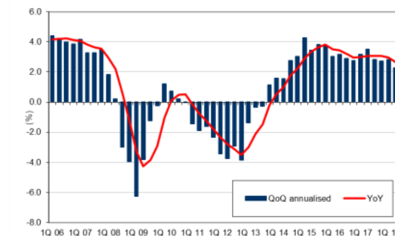
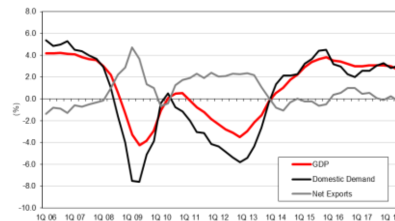
Weaker Spanish 2Q18 GDP made investors more pessimistic about the sustainability of the economic cycle. Digging into the GDP statistics, we believe that this pessimism is unjustified and expect 2H18 GDP to confirm that 2Q was a one-off. Fundamentals are still strong and salaries per employee seem to be starting to pick up. We still see the economy growing by c.3.0% in 2018-19E.

Chart 19: GDP, 2006-2Q18



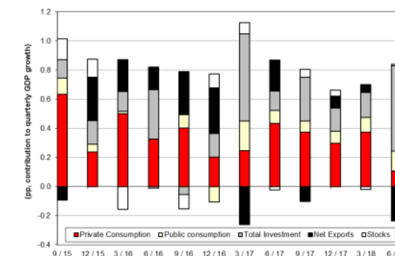
Source: INE, Santander.

Chart 20: GDP breakdown, 2006-2Q18



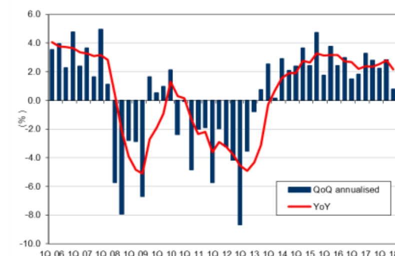
Source: INE, Santander

Chart 21: GDP breakdown, 2015-2Q18



Source: INE, Santander.

Chart 22: GDP - Private consumption, 2006-2Q18



Source: Eurostat, Santander.

Weaker Spanish 2Q18 GDP numbers: Is the Spanish economic "miracle" over?

In recent weeks and following lower than expected 2Q GDP growth in Spain, showing the lowest growth in private consumption since 2Q14, we have heard some investors voice concerns that Spain's secular macroeconomic growth trend might be over. We believe that the Spanish economy is still doing well and will continue to do so in the near future, and do not agree that the current "relative pessimism" on the country's future macro performance is justified. The most important macro release recently has been 2Q GDP growth, which came in at 0.56% QoQ, versus consensus expectations of 0.7% and our 0.68% estimate. This was the slowest quarterly growth rate since the 0.39% QoQ reported in 2Q14. The economy clearly lost pace in 2Q18, after surprising to the upside in recent years. GDP growth has been above 3.0% in the last three years, and will probably move slightly below that level in 2018E. In fact, the annual GDP growth rate declined in 2Q18 to 2.7% from 3.0% in 1Q18, hitting the lowest rate since 2Q14.

2Q18 GDP breakdown: the numbers were not that bad…

We believe that the 2Q numbers were mixed and, looking at the breakdown, the lower growth was largely due to one-off factors, so in 2H we expect growth to recover and are not concerned about Spain's macroeconomic situation for the medium term; we stick to our GDP estimates of 2.9% for 2018E and 3.0% for 2019E. The analysis of 2Q18 GDP shows the following:

- An extremely weak performance in private consumption, which grew by just 0.2% QoQ (the lowest rate since 1Q14) after 0.7% in 1Q18. Its contribution to quarterly GDP growth fell to 0.11pp in 2Q18 from 0.37pp in 1Q18.

- A negative contribution of net exports to quarterly GDP growth of 0.2pp, reflecting a 0.26% decline in imports and a drop of 0.96% in exports.

- Against these negative performances, we had investments growing by 2.64% QoQ in 2Q and an extremely solid performance from both construction (+1.07% QoQ) and capital goods (machinery and equipment +5.65% QoQ and transportation equipment +11.27% QoQ). The contribution of investments to 2Q18 GDP growth rose to 0.59pp in 2Q18 from 0.17pp in 1Q18. Public expenditure also performed quite well (+0.72%).

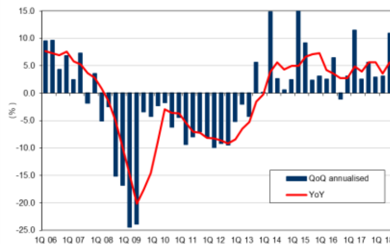
- As a result, internal demand actually performed better in 2Q (+0.83%) than in 1Q (+0.67%). These are all QoQ changes, so highly noteworthy figures. Furthermore, domestic final sales outpaced the 1Q figure (+0.7%) in 2Q, reaching +0.8%.

So what happened to private consumption and why are we not concerned about its future performance?

In our view, consumption was negatively affected by certain factors that are unlikely to be repeated in 2H18.

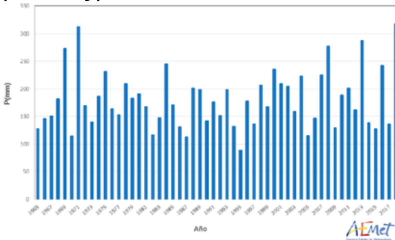
1) Very bad weather in 2Q had a negative impact on consumption. According to our contacts in the retail sector, sales were poor because there were too many rainy days in spring, and we believe

Chart 23: GDP- Investments, 2006-2Q18



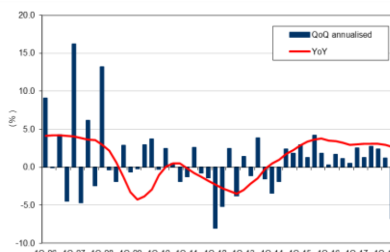
Source: INE, Santander.

Chart 24: Spain- Total rainfall in spring (Mar-May), 1965-2018



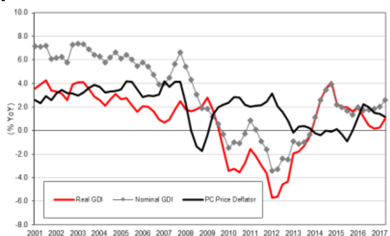
Source: AEMet (Agencia Estatal de Metereología).

Chart 25: GVA-Arts, entertainment and other services, 2006-2Q18



Source: INE, Santander.

Chart 26: Nominal vs. real GDI and PC price deflator, 2000-1Q18



Source: BoS, INE and Santander.

Chart 27: Average earnings, 2006-2Q18

Source: Santander estimates.

this effect will disappear in 3Q. In that regard, it is interesting to look at the Spanish rainfall statistics. According to official weather data, spring 2018 (March-May) was quite wet, with average rainfall of 317mm, which is 83% higher than the historical (1981-2010) average for that period. Based on the data available, this spring has been the rainiest since 1965, followed by the spring of 1971. Both March and April 2018 were extremely wet.

Interestingly, as an example, when we look at the GVA performance of the different sectors, we find that the arts, entertainment and other services sector experienced a sharp decline (-1.7% QoQ) in 2Q18 from an increase of 0.3% QoQ in 1Q18. This was the first negative figure reported since 2Q14 and the worst since the -2.1% QoQ posted in 1Q12, when the Spanish economy was in a deep recession. In our view, this poor performance was due to weather conditions and could therefore revert in 2H18E.

2) The increase in prices was mostly driven by the energy component, which has held back real GDI (gross disposable income) growth rates since last year and ultimately final consumption.

What should we expect going forward?

As we have noted in the past, the main risk for Spanish GDP growth in our opinion is a lack of strong growth in nominal GDI in a context of rising inflation. The main source of increased income so far has been employment creation, while salaries per employee have not yet gone up substantially. In the end this clearly limits income generation and consumption amid rising prices.

Recent numbers suggest that this is progressively changing, and in our last "Thinking Macro" study we calculated that the base effects of inflation would start improving in 2H18, and together with stronger growth rates in salaries per employee, should push up real income metrics during the rest of the year and 2019, thus driving a recovery in consumption. In that regard, 2Q18 numbers are quite reassuring, since:

- Salaries per employee went up by 0.7% YoY in 2Q18 from 0.4% YoY in 1Q18, 0.1% in 2017 and -0.3% in 2016. Salaries in construction fell by just 0.1% YoY, while they rose by 0.9% YoY in services, with public administrations showing an increase in salaries per employee of 0.4% YoY. It therefore seems that we are heading for a positive trend that should boost salaries per employee growth rates above 1.0% this year.

- Employment creation remains strong, rising by 0.8% QoQ in 2Q18 from 0.5% Q/Q in 1Q18, and growing by 2.5% in annual terms.

The main risk is seeing GDP growth rates moving towards 2.5% from above 3.0% in recent years

While we see the main risk for future economic growth as a lack of strong nominal GDI growth in a context of rising prices, this would not imply a collapse of the Spanish economy or anything similar, and would simply mean lower annual GDP growth rates (maybe 2.5% instead of 3.0%)..

Euro Rates Strategy: All eyes on periphery, with core rates looking sluggish

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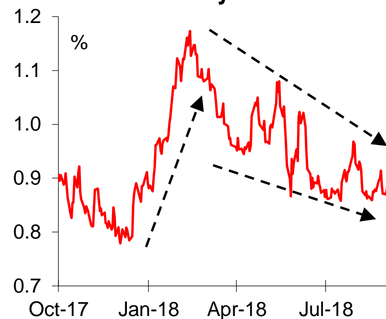
- **EUR rates have traded sideways to lower due to loose policy, and risk-off sentiment. Policy normalisation will continue in 2019, however. Market rates should rise, albeit slowly.**
- **Policy risk in Italy is the key near-term issue, with budget negotiations in September and October. Implied credit risk seems high but volatility makes BTPs less attractive.**
- **Given the more solid data and much lower policy risk, Spanish risk premia seem a better position, right now.**

Chart 28: Euribor 10y rate



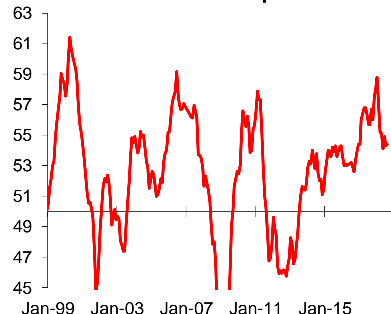
Source: Bloomberg, Santander

Summer pause for core EUR rates.

Even before this summer, a salient characteristic of the sell-off in Euro area core rates that began **from the September 2016 all-time lows** was the very slow rate of increase in those rates. **On average, 10y Euribor rates have increased by only around 11bp per quarter** (just 8bp for 10y Bund). Even by that modest standard, price action over much of the summer has been particularly subdued. The 10y (and the 5f5y) rates **have been printing lower highs and lower lows since late February** (Chart 28). The lack of a strong rates-bearish trend can be explained by several factors:

- Macroeconomic data have shown very little upside momentum, at the G7 level. That is **especially true for the Euro area**. Core y/y inflation has been limited to a 0.8%-1.1% range since September last year and the latest (flash) figure showed a small deceleration from 1.1% to 1.0% y/y. Euro area real GDP growth appears to have peaked at 2.8% y/y late last year and has since decelerated to 2.5%, then 2.2%. The manufacturing PMI is now six full points below its (albeit quite high) peak set last December (Chart 29).

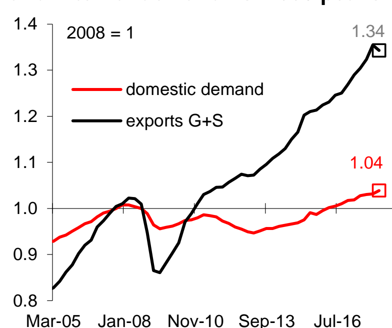
Chart 29: Euro area composite PMI



Source: Reuters, Santander

- **The ECB** is sticking to a very cautious (prudent, patient, persistent) stance on monetary policy. This is currently embodied in the modest extension of the APP to year-end and, especially, by enhanced forward guidance. The **expectation that policy rates will remain unchanged until late summer or autumn 2019** (and, implicitly, will rise gradually after that), **is fully incorporated into market pricing**.
- A number of latent risks have affected pricing, from **elevated Italian sovereign risk premia** (which we discuss below), to **volatility in emerging market currencies** to **concerns about the global trading system**. Trade, freight and commodity indexes have shown some softness and **the demand side in the Euro area is heavily dependent on the external sector**, with gross exports up roughly 30% from pre-crisis levels while domestic demand is less than 5% above that starting point (Chart 30).

Chart 30: Relative growth of external and internal demand vs. 2008 peaks

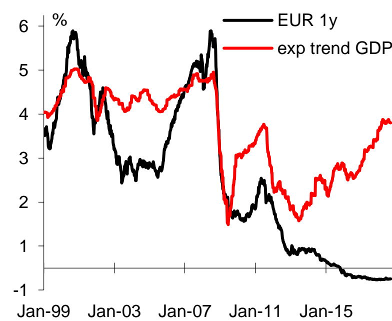


Source: Eurostat, Santander

Policy normalisation, though slow, is still on track

Given this litany of downbeat factors, why do we expect rates to rise at all? While the factors listed above certainly merit consideration, we must keep in mind that global developed country rates have been and are likely to remain strongly correlated and that, on balance, **there are more reasons for G7 rates to rise, under current conditions, than otherwise**.

Chart 31: Rates and policy trail macro data by a wide margin



Source: Bloomberg, Eurostat, Santander

- Notwithstanding the modest deceleration in Euro area real GDP growth, the overall picture for **nominal GDP growth** there and across the main developed-economy currency areas **is much more robust that one might surmise going by the depressed level of Euro area rates**. This state of affairs reflects the twin forms of easy policy / financial repression put in place by the main central banks following the financial crisis.

- The aforementioned easy policy might be tightened extremely slowly but *it is* being tightened. On a GDP-weighted basis, the **average policy rate** for the US, Euro area, Japan and UK is about 70bp above the lows of 2016. We estimate it **will increase** by another 60bp in 2019 and a further 35bp in 2020. Similarly, at the global level, **QE has essentially peaked and will be shrinking back through the next few years** (as a percentage of government paper outstanding). This process should allow medium- to long-term rates to re-establish a more substantial term premium over policy rates.

In terms of positioning, we have two main trades to express a gradual rate rise with low carry costs (necessary due to the slow pace of rate increases). We have had these on for some time but the trades still make sense and are close to their entry levels.

Trade idea: Higher 10y real rates

Pay 10y Euribor IRS and receive 10y ILS (EMU ex-tob. HICP). The real 10y Euribor rate is now at -0.66% and we target -0.45%.

Trade idea: EUR 5s30s 'bearish' flattener

Pay 5y IRS fixed and receive 30y IRS fixed. The current spread is 120bp. We target a test, then break, of the 106bp low. The 3-month carry cost on such a flattener is roughly 1bp.

Periphery volatility led by Italian spreads

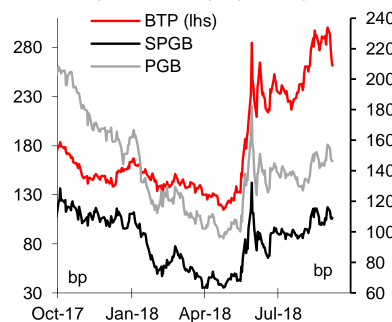
It seems a distant memory now, but as recently as April most 'periphery' sovereign issuers printed post-crisis lows in their spreads over German paper. Among others, this applies to Spain, Portugal and Greece. In general, periphery sovereign spreads were stable and relatively low. Beginning in May, the volatility and level of such spreads increased substantially and remain elevated, with Italian bonds leading the way and essentially providing the main justification for periphery EGB underperformance. The two key questions facing EGB-focused investors at this point are:

a. where are Italian risk premia headed, after the recent correction and

b. is it worth being long (overweight) other periphery paper?

The precise news flow to which spreads have reacted has evolved somewhat from Q2 going into Q3. Concerns about generic political instability and Euro-scepticism are less prominent now, partly because they have been overtaken by events. **The main area of focus for investors now is the extent to which the 5-Star + League government coalition will reverse Italy's tentative gains on the fiscal balance front**. As fiscal experts have estimated, delivering on all the promises contained in the government programme would cost between €50bn and €100bn per year (3-6% of GDP).

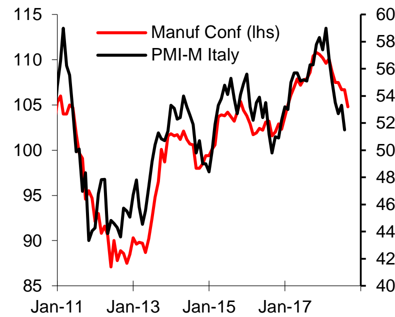
Chart 32: Volatility remains high in periphery spreads (10y CMT)



Source: Bloomberg, Santander

The **last target agreed between Italy and the EC** (before this government was formed) was for a general government deficit of **1.7% of GDP** in both 2018 and 2019. We would expect some leeway, but well short of full fiscal loosening. **As much as the final figure, the tone and approach taken by the Italian government is relevant**. Politicians have to navigate between confrontational declarations, which have correlated with higher poll readings, and a more collaborative approach. Over the past few sessions, the main party leaders have taken a softer stance, which has partly reassured markets. Despite the high poll readings, the latest measures of **economic sentiment and the Reuters PMI for Italy have clearly accelerated their downward move in the summer months**, when the Eurosceptic rhetoric was at a peak. The updated budget estimates are meant to be presented by mid-September, with the budget law going to the EC and Italian parliament in October. A related issue is the path of **Italy's ratings, which are now on negative outlook for Moody's and Fitch**. S&P is also due to review the rating in October.

Chart 33: Sharper drops in Italian business confidence



Source: Bloomberg, Santander

To the budgetary issue, we would add two further concerns. The partial **roll-back of recent labour liberalisation reforms could undermine the moderate but encouraging gains made in Italy's employment growth** in recent years. This line of economic policy-making, in our opinion, is ultimately more threatening than the odd 1% in annual deficit figures. Furthermore, with roughly another €40-45bn to place before year-end, the **reliance on domestic institutional investors** could become a burden. We know from official figures and anecdotal evidence that foreign investors have sold tens of billions of Italian paper since the March elections, against roughly €22bn bought by the APP. **Domestic banks' holdings of government paper is back to over 90% of capital.**

Chart 34: Domestic government bond holdings as % of capital in Italian banks

Source: Bank of Italy, ECB, Santander

Against that list of potential problems, we have to weigh current valuation levels. **Over a five-year period, the cumulative implied probability of a credit event is 19%**, if we posit an actual default (with a loss-on-default assumption of 54%[1]) **or 25% if we posit a redenomination** (assuming a 40% currency depreciation[2]). Those levels have corrected from even higher ones late last week. The data sample of developed-economy defaults is far too small for statistical inference but **those percentages seem, subjectively, exaggerated to us**. On a forward-looking return basis, even if the elevated return volatility remains in place, BTPs look good value. On the other hand, on a short-term basis, the extra running yield on BTPs is not much compared to the MTM loss of the sort of yield moves we have experienced recently. Despite the generous risk premia, **we still think that EGB-benchmarked investors should remain underweight BTPs or at least neutral**. Let us bear in mind that we have not seen any detailed figures yet. In terms of positioning, we recently recommended a 5s15s BTP-Bund box spread steepening, which hit its target more quickly than expected due to the bullish price action.

Spanish risk premia seem attractive to us

The (much less pronounced) widening of non-Italian sovereign spreads has coincided with developments in Italy and we doubt that such volatility would have occurred in SPGBs based only on domestic issues. Nonetheless, it is worth pointing out two issues that have attracted some attention from investors concerning Spain.

- Exposure of Spain to emerging market financial systems (like Turkey

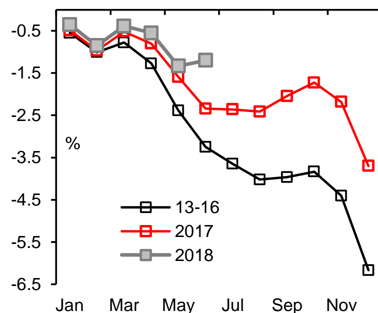
[1] This is based on a reduction of the general government burden from 129% of GDP to the 'canonical' 60% of GDP level. The IMF/IBRD recommended sustainable standard is 250% of tax revenues or 150% of exports which, for Italy, would be a range of 45-70% of GDP.

[2] Following the EMU crisis of 1992 and depreciation of 1995, the medium-term devaluation was roughly worth 30% and 40% peak-to-trough.

and Argentina) that have recently been under market pressure. The Spanish banking system has substantial, though not systemically threatening, exposure to those economies[3].

- Political and policy risk within Spain itself. The PSOE-led government has pursued a number of policy initiatives, including raising the spending ceiling going forward. The evidence to date is that, given its very low number of seats (less than a quarter in both the Senate and Congress of Deputies), the PSOE has limited scope for policy implementation. Support from Podemos and other parties that voted to oust the PP's Rajoy is not obvious, either.

Chart 35: Spanish GG fiscal balance as a % of GDP



Source: IGAE, Eurostat, Santander

Notwithstanding the moderate EMU-wide deceleration, **Spanish growth remains robust**, at 2.7% y/y in real terms and 3.4% in nominal terms as of Q2. Job creation is clearly positive and fiscal figures are benefitting as a result (Chart 35). Considering Spain's lower debt/GDP ratio, a higher recovery upon default would be expected. Factoring that into current spread levels, **the 5-year cumulative default probability implied by the market is more than 8% (and nearly 25% over ten years…). Again, we view such probabilities as strongly over-stated.**

Despite the lingering spread volatility, we have maintained an overweight recommendation on Spanish (and Portuguese) government bonds. The main tracking trade we recommended is now at a wider spread starting point. Such volatility is to be expected but we believe that it will ultimately prove a rewarding trade.

<u>Trade idea:</u> Overweight SPGBs in EGB portfolios

Buy: SPGB 1.4% Jul-2028

Sell: Bund 0.25% Aug-2028

The spread is 106bp and we target 70bp. The carry is positive at ½ bp per month.

[3] BIS figures for March 2018, place the exposure of Spanish banks to Turkish and Argentine credit at US$81bn and US$28bn, respectively. This compares to total consolidated assets of €2.7 trillion and capital and reserves of €287bn.

Euro government bond supply: YTD update

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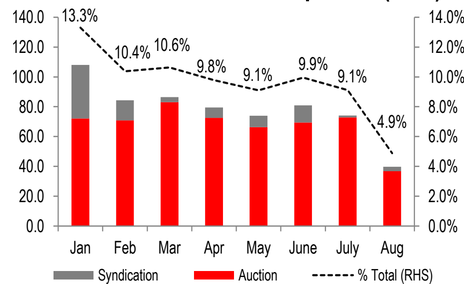
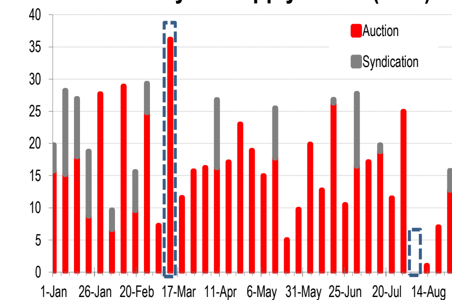
Chart 36: YTD issuance completion (€ bn)



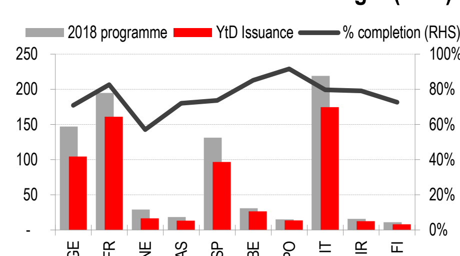
Source: Bloomberg, Santander

Chart 37: Weekly EZ supply – YTD (€ bn)



Source: Bloomberg, Santander

Chart 38: 2018 YTD issued vs. target (€ bn)



Source: Bloomberg, Santander

Table 3: YTD issuance completion vs. historical data

	2013	2014	2015	2016	2017	2018	Aver 13-17
GE	67%	67%	71%	75%	71%	**71%**	70%
FR	70%	69%	71%	73%	71%	**83%**	71%
NE	78%	75%	75%	68%	64%	**57%**	72%
AS	60%	63%	71%	61%	63%	**72%**	64%
SP	73%	73%	75%	73%	72%	**74%**	73%
BE	82%	76%	71%	77%	77%	**85%**	77%
PO	100%	66%	72%	85%	75%	**92%**	80%
IT	67%	72%	73%	69%	73%	**80%**	71%
IR	100%	60%	85%	67%	61%	**79%**	75%
FI	81%	79%	86%	85%	79%	**73%**	82%
TOTAL EZ (€)	**70%**	**71%**	**73%**	**72%**	**72%**	**77%**	**71%**

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

- **Euro area issuers as a whole are near the 80% mark for their combined govie bond financing requirements for 2018**

By the end of August, EUR issuers had sold more than €625bn worth of bonds and linkers (of the €813bn expected for 2018) via both ordinary auctions (€543.7bn) and syndicated deals (€83.5bn). We are seeing a slight slowdown in issuance activity caused, in part, by the situation in Italy with its new government, and the trade tensions between the US and its commercial partners, not to mention the summer break. Chart 36 shows EUR countries' issuance in the first eight months of the year and we can clearly see that activity in the first quarter of the year was higher than in the second, but then in the last two months activity has fallen despite the continued support of the ECB's EAPP.

In August, as usual, EUR govie bond supply dropped as activity practically dried up, with only Germany and Italy issuing debt. But in July, bond supply remained more or less the same as in previous months, reaching €73bn, or 9.1% of the Eurozone's 2018 combined issuance requirements, while in August, the figure did not surpass the €40bn mark (or 4.9% of the combined target).

The region's weekly average issuance was very near €18bn over the period to the end of August (vs. €19.5bn seen at the end of July). So far this year, the second full week of March (commencing 12 March) has still seen the largest weekly volume, with €36.2bn placed, including syndications, while, as expected, the week commencing 6 August shows no activity at all. The following week, however, has the lowest volume of the year, at just €1bn, as seen in Chart 37.

In terms of total issuance by country, shown in Table 2 below, as of 31 August Italy is at the forefront, with around c.€175bn, which includes the BTP Italia retail bond sale in the middle of May. France (with €161bn) is in second place and Germany comes in third (with €104.3bn), while Spain follows behind with €96.7bn. The rest of the Euro issuers have not yet surpassed the €20bn mark, with the exception of Belgium, which has issued €26.4bn so far. The Netherlands (€16.5bn) comes next, followed by Austria and Portugal (both above €13bn), Ireland (€12.7bn) and, finally, Finland (€8bn).

In terms of YTD completion rates by country, at the beginning of September, Portugal continues to lead the Euro area issuer ranking, with 92% placed, followed by Belgium and France (85% and 83%, respectively). Italy is at 80%, while Ireland is near the 80% mark, with 79%. Next, we have Spain, Finland, Austria and Germany with 73.6%, 73%, 72% and 71%, respectively, in the 70%-plus club. Lastly, we have the Netherlands (57%), which is the laggard this time (see Table 2 for more details).

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

	GE	FR	NE	AS	SP	BE	PO	IT	IR	FI	TOTAL EZ (€bn)
YtD auctioned issuance	104.3	153.6	16.5	8.6	73.7	16.9	5.7	157.8	4.7	2.0	543.7
YtD syndicated issuance	0.0	7.5	0.0	4.8	23.0	9.5	8.0	16.7	8.0	6.0	83.5
YtD Issuance	104.3	161.1	16.5	13.3	96.7	26.4	13.7	174.5	12.7	8.0	627.2
2018 programme	147.0	195.0	29.0	18.5	131.3	31.0	15.0	219.0	16.0	11.0	812.9
% completion (RHS)	71%	83%	57%	72%	73.6%	85%	92%	80%	79%	73%	77.2%

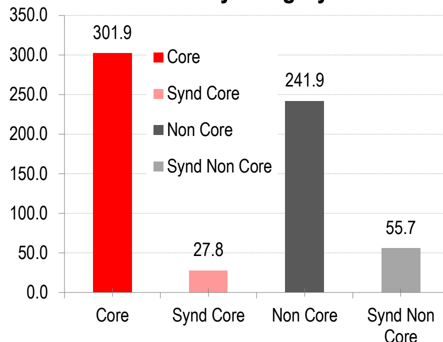
Source: Bloomberg , Santander

As shown in Table 3, a number of EUR issuers have succeeded in frontloading their bond issuance this year, taking the average completion rate for the region as a whole (currently at 77%) to above

the levels seen at this stage in previous years (e.g. 73% in 2015 or 72% in 2017). According to our analysis, Belgium (85% vs. 77%), France (83% vs. 71%), Austria (72% vs. 64%) and Italy (80% vs. 71%) outperform their average figures for the past five years, with all of them setting new record highs for that period. On the flip side, Finland (73%) and the Netherlands (57%) remain clearly behind the curve, as their completion rates are the lowest in the past five years. Nevertheless, given the comparatively small issuance in these countries, a move back to average would only require €1bn and €4.4bn, respectively – an extra amount that, in our view, should be easy to raise in the primary market over the remainder of 2018.

When comparing 2018 to last year's completion rates, this month Ireland is at the top, exceeding its 2017 average by 18pp, followed by Portugal with 17pp, and both are issuing faster than in the last four years. France, Austria, Belgium, and Italy are next, being 12pp, 9pp, 8pp and 7pp ahead, respectively. Then, we have Spain and Germany, which are currently advancing at or around the same pace as in 2017, while the Netherlands and Finland are both 7pp behind (Table 3).

Chart 39: Issuance by category – YTD

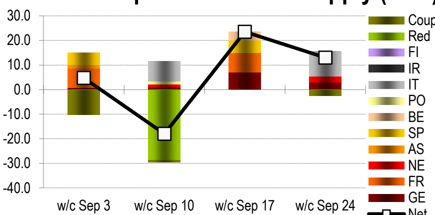


Source: Bloomberg, Santander

Core countries ahead of their periphery counterparts

At this point of the year, total core supply surpasses non-core supply, albeit with slight less activity in both areas. Core issuance accounts for 52.6% of the total, or the equivalent of c.€330bn, while periphery supply makes up the remaining 47.4%, or c.€298bn. The core countries have auctioned 1.25x more than the peripherals (€302bn vs. €242bn) so far in 2018, while the non-cores have placed 2x more via syndicated deals than their core counterparts (€55.7bn vs. €27.8bn).

Chart 40: Expected EGB net supply (€ bn)

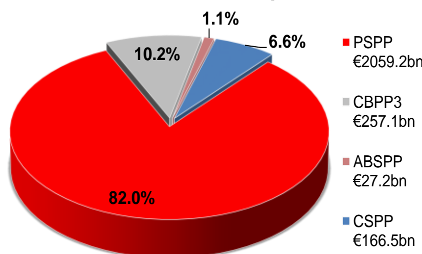


Source: Bloomberg, Santander

September dynamics to play against EUR govies

As shown in Chart 40, apart from August, September has some of the lowest monthly reinvestment flows of the year, as more than €40bn will return to the markets in cash. So, the September supply dynamics should not play in favour of the upcoming auctions. The €28bn maturing (in Germany, Finland, and Italy) and the €13.5bn returning to the market in coupon payments will not be enough to offset the €66bn expected to be auctioned during September. As a result, net EUR supply will be positive by around €23bn.

Chart 41: The ECB's EAPP portfolio



Source: Bloomberg, ECB, Santander

Update on the ECB's EAPP

On 3 September, the ECB published an update of its Extended Asset Purchase Programme (EAPP) holdings, which includes the purchases settled as of 31 August and totals €2,510.2bn in assets acquired since the programme began in March 2015, including corporate bonds. According to the report, the PSPP portfolio has a total of €2,059.2bn in Euro govies, accounting for more than 82% of the ECB's monetary policy portfolio; while the CPBB3 and the CSPP holdings now amount to €257.1bn and €166.5bn, respectively, equivalent to 10.2% and 6.6% of the portfolio, and lastly, the ABSPP now stands at €27.2bn, representing the remaining 1.1%.

By country, the latest information available is a breakdown of PSPP debt security holdings published by the ECB at the end of August, which we commented on in detail in our MMD report published on 4 September. In summary, August sovereign bond purchases totalled €22.6bn, which is lower than the ECB reported for July (€25bn), as expected, bringing total PSPP holdings to €2.1trn at the end of August.

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- **Concerns over a 'no-deal' Brexit outcome have intensified**
- **Timescale around the Article 50 negotiations continues to slip, while the EU's opposition to the UK's proposed trade plan have become more vocal**
- **Northern Ireland backstop plan remains the most likely trigger for a 'no-deal' outturn**

No deal - Clear and present danger comes into view

Despite constituting a 'clear and present danger' to the UK outlook since the very beginning of the Article 50 negotiations, the prospect of a 'no-deal' outcome to the Brexit process, and the likely implications for the UK economy, have come into much sharper focus in recent weeks.

These increased concerns relate in part to the declining period for negotiation ahead of the UK's scheduled March 2019 exit from the EU, and the reportedly growing likelihood that the October EC Summit – long viewed as the most likely juncture for an accord to be struck on the withdrawal agreement – may now pass without any such resolution being achieved. But we believe that the more likely driver of the recent 'no-deal' anxieties is the EU's increasingly vocal criticism of key aspects of the UK's proposed trade plan. Importantly, such opposition relates not only to the more theoretical defence of the integrity of the EU Single Market (and the indivisible nature of the four key freedoms), but also misgivings regarding the actual feasibility of the UK's proposals, in particular the plan for a facilitated customs arrangement to exist between the EU and UK from 2021 onwards.

As we have stated in previous research documents (see 'Wishful thinking on a soft Brexit', published 13 July 2018), we believe that several aspects of the UK's so-called 'Chequers Plan' fail to withstand close scrutiny. From a broad view, the prospect of frictionless trade with the EU under the Chequers Plan – should the UK actually exit the customs union as planned – will continue to rest upon the willingness of the EU to effectively delegate its customs enforcement to a non-member country. Chief EU negotiator Michel Barnier's opposition to this key aspect of the UK's proposals has turned more vocal in recent weeks, declaring in a widely published Op-ed article on 2 August that the UK "cannot ask the EU to lose control of its borders and laws". But, within the detail of the UK's plan, we also believe that the proposals relating to rules of origin requirements will likely prove contentious to the EU. Establishing common ground on exactly which elements of the EU's product regulations require UK adherence in order to ensure frictionless trade may also prove a further, key stumbling block.

Staggered approach is a key complication for the UK

More critically, however, we remain concerned by what we believe to be a fundamental mismatch between the EU and UK's respective negotiating positions which, in theory, could yet aggravate 'no-deal' concerns in the coming weeks, even as both parties seek to avoid such an outcome.

From an EU perspective, arriving at an agreement on the future trade relationship still appears very much secondary to concluding the withdrawal agreement, with the EU's proposed trade plan centred around a 'Canada-plus', zero tariff, zero quota deal for goods alone. But, from a UK perspective, we argue that securing an agreement on the future trade deal – or at least the achievement of substantial progress on this front – is central to the prospects of solving the Northern Ireland backstop issue, and in turn achieving a

smooth and orderly Brexit.

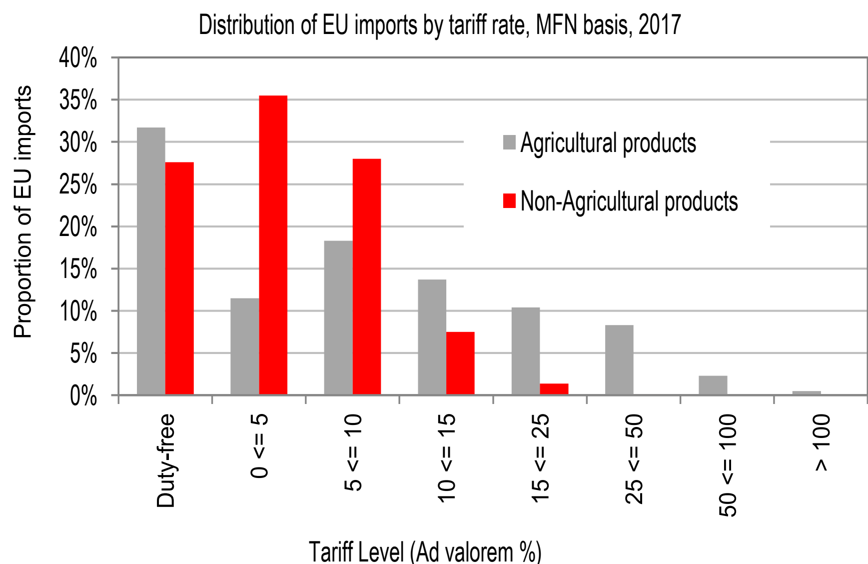
The UK government will likely continue to insist upon a time-limited Northern Ireland backstop scenario, such that the UK can avoid an extended and involuntary membership of the EU customs union from 2020 onwards, or alternatively the emergence of a hard border between Northern Ireland and the rest of the UK. However, unless progress can be achieved regarding the eventual trade deal with the EU - which would eventually render the Northern Ireland backstop unnecessary, and thereby support the concept of a time-limited deal on the Irish border - then the ability to reach a withdrawal agreement with the EU will also be uncertain. As such, we regard the EU's more vocal opposition to the central element of the UK's Brexit white paper as a significant event, highlighting the fault lines which exist between the UK and EU's respective positions as the remaining period for negotiation steadily declines.

Border problems, broader concerns

Until an agreement is achieved on the Northern Ireland backstop, the UK's orderly withdrawal from the EU – and the implementation of the transition period – cannot be viewed as a given, and within the current environment attention has naturally moved to the potential impact of a 'no-deal' event on the UK economy.

From the outset, we would stress that a 'no-deal' outcome would constitute an unprecedented event for a major, modern economy such as the UK. The degree of visibility on the immediate economic impact will, as a consequence, be much reduced. The recent introduction of tariffs on the import of steel and aluminium products into the United States, for instance, has sparked a flurry of research notes and a broader discussion about the likely impact upon US growth and inflation. But these actions constitute a tiny fraction of the potential implications that would be presented to UK trade from a 'no-deal' outcome.

Chart 42: Distribution of MFN tariff levels for EU imports



Source: WTO, Santander

Non-discriminatory rules imply non-zero tariffs…

Under any 'no-deal' outcome from April 2019 onwards, we assume that UK-EU trade will simply revert to a so-called 'third country' status, which would also be applicable to the numerous countries currently covered by EU free trade deals (e.g. Mexico, South Korea, Ukraine). Given the non-discriminatory (Most Favoured Nation, MFN) basis of WTO rules, the UK may be unable to set a zero tariff on imports from the EU. Such a move would leave the UK unable to apply a non-zero tariff to the imports of any other country, thereby (in theory) presumably providing a sub-optimal negotiating position for future trade deals.

We have typically assumed that the level of UK tariffs would simply be set to match those of the EU, given that the existing UK customs framework already operates on these terms. This position has subsequently been confirmed by the release of the UK government's 'no deal' contingency papers, and Chart 42 provides a breakdown of these MFN tariff rates imposed upon EU imports. While roughly 28% of the value of non-industrial goods imports attract no tariff at all, some 7.5% of non-industrial goods imports attract a tariff level of between 10 and 15%-pts.

…and a significant hit to CPI inflation…

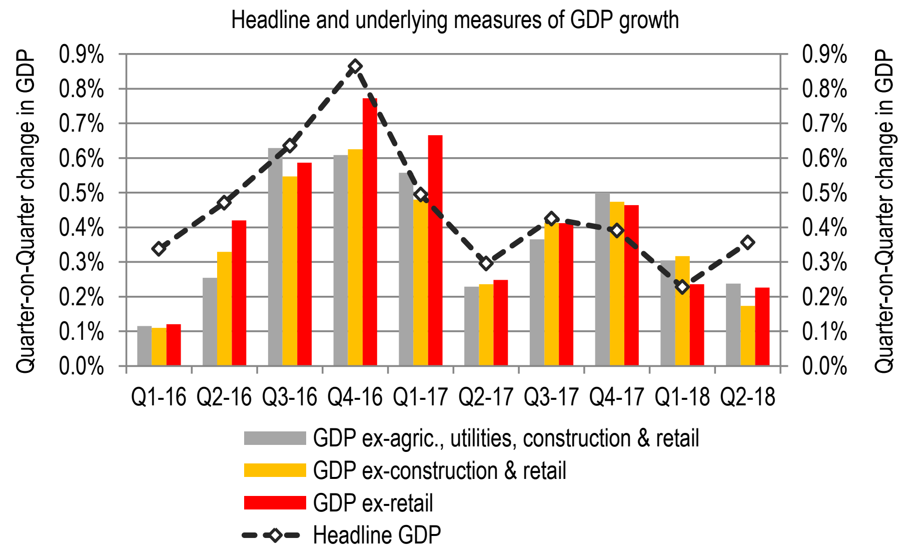
Importantly, and distinct from the inflationary pressure caused by a rise in value added tax, the inflationary impact of the potential imposition of tariffs would therefore prove highly variable across the economy's differing sectors, with tariffs on clothing typically centring around the 12% level, while many electrical goods attract tariffs closer to zero. But, when taking into account the direct import intensity of the various components of the CPI, the proportion of these goods imported from the EU, and the tariff that would be applied under WTO rules, we estimate that a percentage point increase in the annual rate of CPI inflation could easily occur, even before any currency-related price pressures – or those relating to disrupted supply chains – are considered.

…and the UK economy has lost momentum in 2018

The ability of UK consumers to absorb any such inflationary spike would clearly become a key point of discussion for investors should the perceived probability of a 'no-deal' outcome rise in the coming weeks, as would the potential for UK authorities to limit the likely impact upon the UK economy's supply potential.

In the near term (1-2 years), the UK may commit – on a unilateral basis - to adhere to new EU product regulation as it emerges, in order to limit any increase in non-tariff trade barriers with the EU, such as the inspection of goods shipments for product standard / regulatory purposes. In theory, the UK may also opt to unilaterally implement the EU citizen rights directives contained in the draft EU withdrawal agreement, regardless of any failure to secure a period of transition from March 2019 onwards. But a substantive hit to activity would likely still occur, and we remain concerned by the current level of momentum across the UK economy. Measures of core GDP growth – excluding those areas of the economy thought most sensitive to the unusual weather patterns observed during the first half of 2018 – actually reported a slowdown in Q2-18, with the annualised, underlying GDP growth rate holding around the 1% level in H1-18 (see Chart43).

Chart 43: Measures of core UK GDP growth



Source: ONS, Santander

A timeline of (potentially) missed targets

For UK markets, therefore, the prospect of a ‘no-deal’ outcome has the potential to dominate sentiment in the coming months, particular as key milestones in the Article 50 negotiations approach.

As stated above, the European Council meeting / summit on 18-19 October has typically been viewed as the critical date for securing the withdrawal agreement, but, once again, expectations around achieving a deal in October appear to have declined. The proximity of the Conservative Party conference on 30 September – 3 October has also been viewed as a potential complicating factor to achieving a deal at the October EC summit. On this front, the UK’s Migration Advisory Committee is also due to publish its recommendations in September (no fixed date) for the UK’s post-Brexit immigration framework – an area not addressed by the white paper – and this could also prove a key event from a UK political viewpoint.

Should a deal not be achieved in October, then speculation will build about a potential ‘emergency’ European Council meeting being held in November, or instead that the European Council meeting scheduled for 13-14 December becomes the ‘final’ point for a deal to be struck. Of course, any agreement on the withdrawal deal is subject to parliamentary approval across the EU, and so a considerable buffer period will likely be required between striking a deal and the UK’s 29 March 2019 exit date.

Any failure to secure a deal by the end of 2018, however, would effectively place the UK in an extremely uncertain environment. Under the recently implemented EU Withdrawal Bill, the UK government would be required to make a statement to the House of Commons on 21 January 2019, outlining why a deal has not been agreed and what the government’s plans are for the remaining period of negotiation. But it is uncertain (and a point of some controversy) whether the House of Commons, via a parliamentary vote, could effectively force the UK government to adopt a new negotiating position for the remaining six-week period before the UK leaves the EU.

UK Rates Strategy: Market rates remain on hold, despite the BoE

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- **UK rates have also gone nowhere over the summer, and we expect indecisive market conditions to continue for several weeks more.**
- **We no longer see them as likely to achieve a (mild) sell-off before year-end, as Brexit and domestic political uncertainties persist and slower economic growth becomes established.**
- **ASW may look very wide, but we believe they are generally at sustainable levels under these conditions. We also urge looking through FRA/OIS noise and note their greater stability versus Sonia**

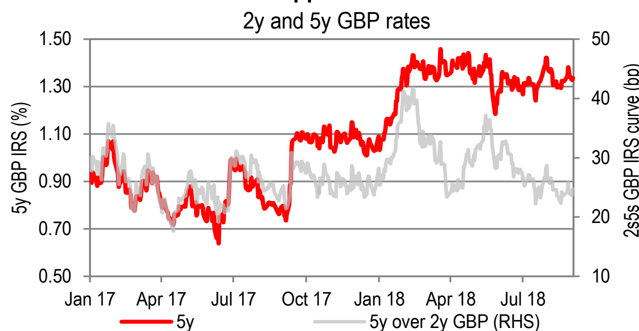
UK rates have lacked any direction, and even much noise…

The GBP market has been remarkably stable over the last couple of months, despite news flow remaining eventful. There has been a mild net sell-off of 5-10bp across the gilt and swap curves since the end of June, with 5y the best-anchored point. But that modest move covers a period that includes the UK's "Chequers Plan", subsequent political intrigues and a run of lacklustre domestic economic data, not to mention Bank Rate being lifted above 0.50% for the first time since 2009.

The market confidently anticipated the rise in Bank Rate, and short rates moved smoothly to accommodate it ahead of the announcement. But longer term rates were barely affected, flattening the front end of the UK curve (Chart 44). Indeed, the Dec'19 short sterling contract is priced at 98.84 at the time of writing, the same price as on 14 June (once the risk appetite swings that accompanied the formation of the Italian government had abated).

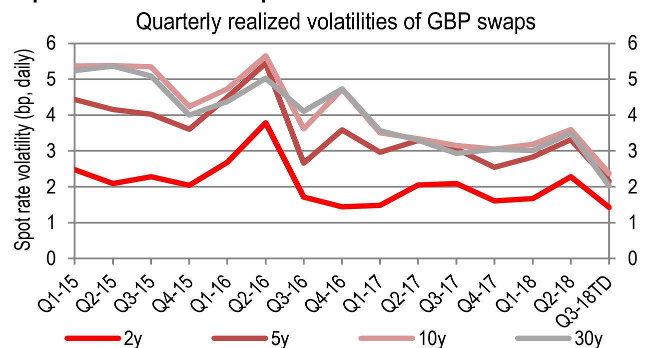
The optical impression of summer stasis can be confirmed in quantitative terms: realized GBP swap volatilities have fallen to their lowest for years, at all tenors (Chart 45). The front end, whose movements have long been constrained by the 'lower bound', had much less volatility to lose in the first place but still followed the trend.

Chart 44: 5y GBP Libor has been trapped in a 1.25-1.45% range for six months, causing the 2s5s curve to gradually flatten as last month's BoE rate hike approached



Source: Bloomberg, Santander.

Chart 45: This quarter has seen the lowest volatility in GBP rates for years, all across the curve: a tangibly quiet summer despite the BoE hike and political turmoil



Source: Bloomberg, Santander.

Even when UK rates have experienced a relatively dynamic day on an eye-catching headline (usually Brexit-related, of course), it has soon proven either an over-reaction or contradicted by another report in the following few days. For instance, the 4bp sell-off on 29 August was inspired by Barnier's "unprecedented relationship" line in Germany, but almost completely reversed the next day once he used interviews to spell out that he referred to the overall package rather than any concession towards a unique trade deal. The speed of going nowhere managed to get even faster on 5 September: short sterling took a 4bp round-trip in two and a half hours, from a Bloomberg news report that Germany was ready to drop its "demand" for a detailed end-state agreement alongside the withdrawal agreement, and a swift rebuttal from German officials.

…and we expect this holding pattern to last for weeks yet

Unfortunately for active investors, we expect these directionless conditions to persist for at least the next month in the UK even if other rates markets develop their own momentum.

First and foremost, markets should be unable to move on until Brexit does. As explored above in the UK Economics section, we see no reason to believe the negotiators are any closer to an acceptable solution to the issues concerning the UK-Ireland border, and the withdrawal agreement will not be signed without one.

The market has shown an inclination to see the glass as half-full on many occasions over the last two years, and will likely find further excuses to sell off over coming weeks – but they are likely to prove just as fleeting as the false starts over the last two months. With officials casting ever more doubt on the prospect of a withdrawal deal being finalized in time for October's European Council meeting, the current market limbo has no end in sight. We note that EC meeting has been truncated to one day to accommodate an Asia-Europe trade summit, revealing both that EU leaders have pressing concerns well beyond Brexit and how low their hopes of a deal by then are.

A second lesson of the summer has come from emerging markets and Italy: when the UK's own unique political/economic problems are not causing a distraction, it has often been because of more acute concerns elsewhere. These two sources of uncertainty have been reinforcing each other and the risk aversion mood, likely raising the barrier to escape from recent ranges.

Markets have little more belief in further hikes than we do

Besides headlines regarding its historic nature and a near-mechanical adjustment of market rates' to the new level of Bank Rate, August's hike has had negligible impact. Focusing on specific dates in 2019 and beyond, using short sterling or Bank Rate forward contracts, gives another extremely horizontal plot since May (Chart 46). Again, the Italy-related price action at the end of May is the most noticeable feature, and the BoE's recent hike actually marked the peak of expectations for another one.

We agree with the market's dubious take on a continuation of the hiking cycle, and forecast the no BoE will undertake no further hikes over the course of next year. This call is not based on the MPC directly accommodating Brexit uncertainty, but rather on the more fundamental signs of decelerating activity and feeble domestic inflationary pressures. Those might be consequences of the Brexit process to some extent, particularly of economic actors' increasing awareness of the devilish details, but we expect the case against further UK monetary policy tightening to become increasingly evident, whatever the ultimate cause.

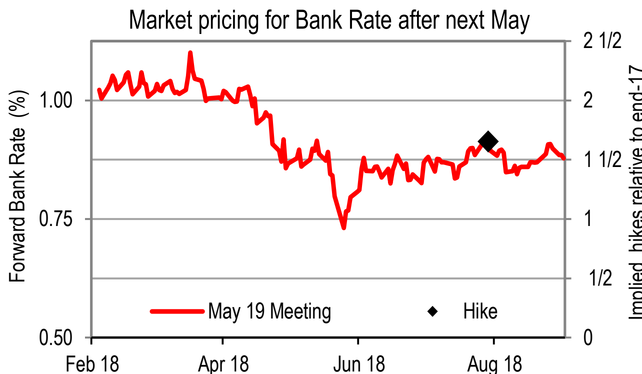
Unfortunately, it is very hard to identify any compelling trading opportunities in this space with market pricing also focused on a near-neutral outlook for Bank Rate. Our central case that rates will remain on hold favours receiving positions, but the tail risk of an improvement in economic conditions in the event of a breakthrough in negotiations cannot be ruled out. With such limited upside if our forecast proves correct, we find the risk/reward of such positions unconvincing (e.g. just 20bp of roll-down between 1y and 1y1y OIS, very close to its one-year low). Even with implied volatilities very low, the breakeven rates for short-expiry swaptions to deliver a profit remain wide enough that they would a require very high conviction on the tail outcomes.

An extended status quo period means low yields and wide ASW can remain justified

The main changes to our overall path of rate forecasts since before the summer, other than incorporating the fact of the BoE hike, has been to push back the (gentle) rises we anticipated by the end of this year. Those were predicated on a Brexit withdrawal agreement being signed off by October's

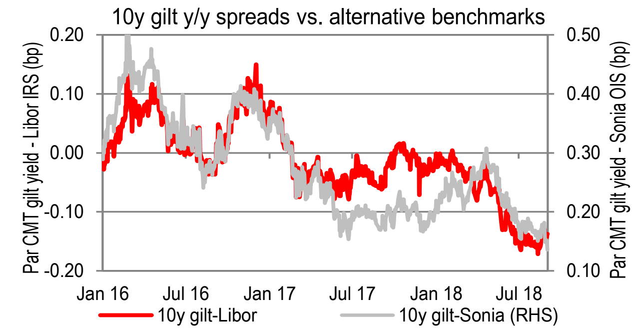
European summit, and an associated sense of relief which would allow UK term rates to make some limited catch-up with the US's lead into year end. Even if such an agreement can still be reached by the end of this year, it now seems likely that the end-state arrangements will be far vaguer and more controversial than we previously expected – and the painfully slow progress so far should have made markets more aware of any fudges that will be included.

Chart 46: Market odds for a third hike in the BoE's 'cycle' by next May been very tightly anchored since April, aside from an Italian political wobble at the end of May



Source: Bloomberg, ICAP, Santander.

Chart 47: 10y gilts are near long-term wides vs. swaps, but the FRA/OIS basis has also moved: gilt widening over the last year looks much more modest vs. (fundamental) Sonia than Libor



Source: Bloomberg, Santander. Note: These are the spreads between 10y CMT par yields from Bloomberg's cubic gilt spline and 10y IRS / OIS rates.

Coupled with the risk-off balance sheet adjustments which are typically seen around year end, we no longer see a material sell-off as plausible for the belly of UK rates over the next few months. Indeed, we see gilt yields as likely to end the year slightly lower than today, and swap spreads a little wider. We still have yields back on an upward trajectory throughout 2019, provided an orderly exit from the EU takes place, but a gentler one than before given the underlying downshift in UK growth which seems to be taking hold.

Gilt swap spreads already look very wide on a historical basis, even after correcting for distortions such as the roll-down over the 4Q 27s' long run as CTD. Constant maturity 10y par yields derived from fitted gilt curves have been hovering about 15bp below 10y GBP swaps, their widest since the full-blown sovereign debt crisis conditions of 2012. Under these conditions of prolonged, deep uncertainty about the UK's economic prospects, not to mention the analogous widening of BTP spreads and fresh EM concerns, the heightened appeal of 10y gilts makes sense. Further, the 'widening' of gilt spreads over the last year has been exaggerated by that of the FRA/OIS basis: when compared to Sonia rates, gilt spreads are still positive beyond 6y and little changes versus those which prevailed during 2H-17 (Chart 47). Again, the risk/reward of positioning for further outright widening does not appeal to us here, but we do see opportunities within the spread curve (e.g. 5s10s or ultra-long box flatteners, and 20s30s box steepeners).

A side effect of these revisions will be a further widening of the UK-US yield differential, but we never saw their recent resistance levels (~160bp for 10y) as any insurmountable barrier. Given that US economic indicators continue to be extremely encouraging, and their contrast with the UK's is growing more stark, further interest rate divergence is arguably overdue.

The long end is an exception to our downward rate revisions, as their credit risk character can outweigh 'safe haven' appeal – and also the greater room for reversal afforded by their even stronger recent performances. Even here, we expect only moderate cheapening, as fiscal discipline seems to remain a government priority and, in the most extreme hypothetical circumstances, the potential for further QE should contain any aversion to long-dated gilts.

Stuart Bennett
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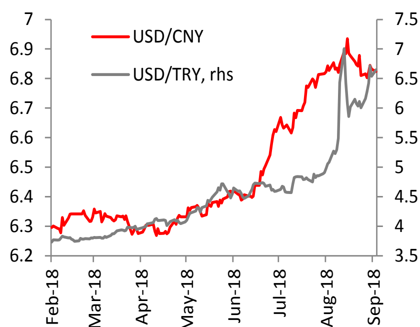
Taken from our latest FX Compass, published 23 August

Chart 48: Risk factors and US protectionism have provided support for the USD…



Source: Bloomberg, Santander

USD – Strength coming to an end?

The USD remains firm amid a mixture of low risk appetite and positive fundamentals. However, after rising 10% since the start of 2018, is the USD index too strong? In technical terms, the answer is probably no. The 10% rise in 2018 is large, but still smaller than the 12% increase posted in H2-16 and the 25.6% jump in H2-14. Plus, it could be argued that 2018's gains still represent only a 50% retracement of 2017's losses.

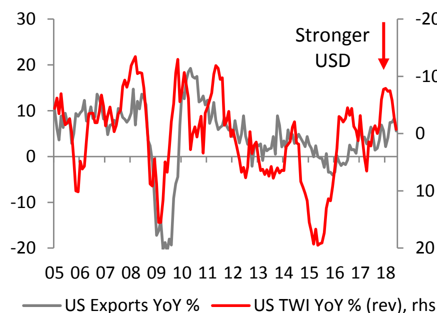
Whilst risk has been the main driver of the USD recently, it is the fundamental backdrop that acts as a sustainable support. The US economy grew 4.1% YoY in Q2 and is expected to outperform its developed market peers in 2018 and 2019. Unemployment fell to 3.9% in July, and economic confidence remains high. Consequently, inflation has risen to 2.9% YoY in July, which we still suspect should be enough to allow the FOMC to hike rates four times more, twice in H2-18 and twice in H1-19.

Interest rates thus remain a USD support. With the exception of the BoC and Norges Bank, other developed market central banks should keep policy on hold well into 2019, with the RBA and RBNZ recently using much more dovish rhetoric. Nevertheless, the USD's weakness in 2017 occurred despite interest rate differentials being in its favour. Hence, the market can ignore the influence of rates on FX when it suits. Further, it might be argued over the coming months that the US tightening cycle is nearing its end, which could encourage some market participants to re-position toward currencies, such as the EUR, whose central banks look set to push up rates in 2019.

However, risk has been the main USD driver. Concerns about the impact of trade tensions with China and the situation with Turkey have undermined risk appetite and boosted demand for the USD as a safe haven. The trade spat between China and the US may prove to have a more lasting effect on the market than the recent focus on Turkey/EM, but both highlight the vulnerability of global sentiment and growth.

The resumption of talks between the US and China is a positive sign, but perhaps not enough to significantly dent the USD. However, if, as the IMF has warned, trade policies undermine global growth, this may have an impact on US sentiment, which could eventually influence Fed rhetoric and make the market question whether all of those extra rate hikes will be forthcoming.

Chart 49: …but we need to reiterate that protectionism does not sit well with a strong USD



Source: Bloomberg, Santander.

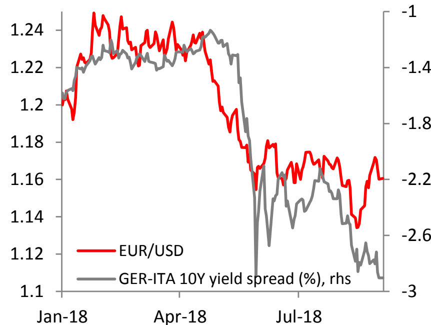
We still highlight the paradox of a market that pulled the USD higher due to US protectionism. A stronger currency should be the last thing that a protectionist would want. In late July and August, President Trump complained about the disadvantage to the US of a strong currency and rate hikes. This increased speculation that the US might intervene to weaken the dollar. We do not think this is likely, particularly given G20 communiqués, which argue against devaluing a currency for competitive reasons. However, given that the US has already walked away from other international agreements, would another matter?

Further, the New York Times reported on 16 August that the US will seek to pressure China to strengthen the CNY. A higher USD/CNY has been the flagbearer for general dollar strength, so if this is ended, it could pull the dollar down against the board.

EUR – Vulnerable to risk

The EUR has been under pressure for most of Q3-18, as low risk appetite has tended to favour a safe-haven bid for the USD and JPY. This pressure does not appear likely to end in the very short term, but with the market very long the USD, having seemingly priced in good US economic news and more Fed rate hikes, there remains scope for the EUR to recover, if the risk backdrop stabilises and the focus shifts to the robust Eurozone outlook.

Chart 50: Eurozone risk versus the EUR



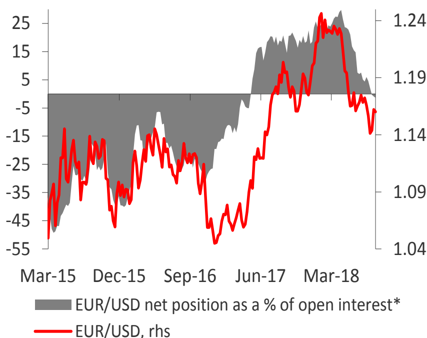
Source: Bloomberg, Santander

The deterioration in risk appetite, which has weighed on EUR/USD, has focussed on two factors. First, trade tensions, primarily between the US and China. Second, concerns about Turkey and its spill-over to other emerging markets. In addition, the EUR has been rattled by worries about Italy's budget plans.

The Turkish panic, the TRY sell-off, and the spill-over to other emerging markets boosted the USD. The knee-jerk reaction has subsided as Turkish policymakers acted to stabilise the currency, but these risks are likely to linger over the coming month. Similarly, intermittent worries about the Italian government's spending plans will be pounced upon as a reason to keep the EUR low.

Hence, the German-Italian 10Y spread (a proxy for EUR risk) has widened. Since the start of 2018, there has been a strong correlation (r=0.89) between EUR/USD and the Bund-BTP spread. The spread hit a low at -2.85% on 15 August, not far off the 2018 low of -2.89%, posted in May when the market was worried about the formation of the new, more 'populist' Italian government.

Chart 51: Speculators have now unwound their net long EUR/USD position, but overall are still very long the USD



*Open interest = total short + long contracts
Source: CFTC, Bloomberg, Santander

In terms of worries about trade, the EUR has been undermined by concerns about global trade tensions' impact on world growth. However, focussing on bilateral trade between the US and the EU, the news has been less EUR negative. At the end of July, the EU and US agreed to suspend fresh tariffs and negotiate on trade.

Unfortunately, fears that a Sino-US trade war might undermine global growth have tended to push the USD higher and drag the EUR down. The FX market still views a protectionist US stance as USD positive. We would continue to highlight that the last thing protectionist policymakers want is for their currency to strengthen, and still believe that if the EUR/USD continues to weaken, the US may become less willing to allow their currency to appreciate, making exporters less competitive.

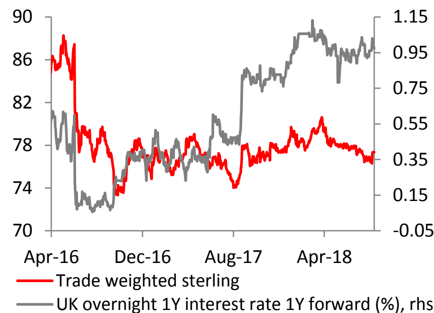
Further, we still feel that the USD is more vulnerable to a protectionist-inspired global slowdown. The US economy remains strong and inflation is high. Indeed, more Fed rate hikes are already priced in. Hence, slower growth/market uncertainty may encourage the market to price out some of those hikes, thereby supporting EUR/USD. Consequently, we still believe that the market is too pessimistic about EUR/USD and too long the USD.

Admittedly, downside growth pressure would also weigh on the ECB. However, with the Bank sticking to its very cautious stance of no rate hikes until after the summer of 2019, there is less scope for it to become even more dovish. Moreover, if global trade tensions ease over the coming months, the market may start to question the bank's cautious stance. The combination of Eurozone GDP growth above 2%, inflation above target and solid economic confidence does not, at face value, indicate an economy that requires its main interest rate to remain at -0.4% for another year.

GBP – What's in the box?

The pound looks likely to remain under pressure. The BoE hiked rates in August, but does not appear in much of a rush to tighten policy again soon. The UK's economic data seem to have improved slightly, but global trade concerns and the threat of a 'no-deal' Brexit remain a risk. In addition, Turkish/emerging market worries have boosted demand for the USD (and JPY), keeping GBP/USD under pressure.

Chart 52: Sterling remains weak, despite BoE rate hikes…



Source: Bloomberg, Santander

The BoE hiked its benchmark rate 25bp to 0.75% at its August meeting. If its economic forecasts prove correct, further 'gradual' rate hikes are likely. As the bank expected, GDP growth improved in Q2-18, with the economy growing 0.4% QoQ, after 0.2% in Q1. In addition, overall, UK economic figures have started to surprise to the upside again.

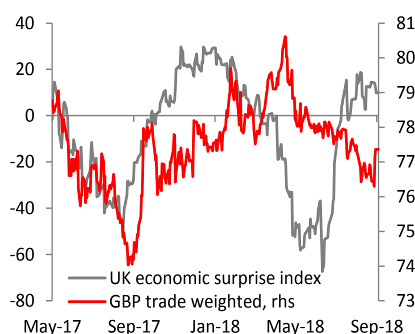
However, the economy's response to 'Brexit' will determine the accuracy of the BoE's forecasts and that will not even start to become clearer until Q2-19. Furthermore, whilst inflation did edge higher in July, to 2.5% YoY, we expect CPI to decline into 2019, and end 2018 at below the BoE's target. Hence, we think that even the gradual rate hikes (an increase every 9-12 months) may prove too hawkish, and expect no change in policy until 2020.

Thus, even though we believe the pound is cheap at its current levels, the mix of declining CPI, a loose monetary policy and risk factors imply only intermittent upside pressure on sterling, which may be viewed as a selling opportunity.

For instance, GBP/USD weakened as the USD was bought as global risk appetite slumped, as a result of worries about global trade and fears about the spill-over effect to other markets from events affecting Turkey. Admittedly, the knee-jerk panic that prompted the FX market to seek the sanctuary of the US dollar could abate, and allow GBP/USD to revisit 1.32 levels, but bigger gains are unlikely as Brexit uncertainty persists.

Indeed, the risk appears to have grown that the UK may not reach a deal with the EU on a withdrawal agreement by late October. Liam Fox, the international trade secretary, warned that the odds of the UK leaving the EU without a deal were "60-40". Further, the governor of the Bank of England cautioned that the risk of the UK leaving the EU without a deal was "uncomfortably high".

Chart 53: …and an improvement in UK economic data



Source: Citi, Bloomberg, Santander

We suspect that the consensus view is still that the politicians will reach some sort of agreement. Hence, failure to do so would imply a GBP negative shock, which could replicate the type of move that was seen after the EU referendum in June 2016. Then, GBP/USD weakened sharply and was around 15% cheaper two weeks after the vote. If replicated on a 'no-deal' outcome, this would imply cable sinking below 1.10.

Such a sharp move may be less likely now, given that the pound is already cheap and may have priced in some of this risk. Plus, a 'no-deal' outcome might become clearer before October and have a staggered impact on the pound. However, the positive impact on the pound from a 'deal' outcome may not be symmetrical to 'no-deal'. The pound would likely rise, but with much uncertainty surrounding future trade arrangements between the UK and EU, the market may be reluctant to pull it significantly higher.

Table 4: G10 FX forecasts

	Q3-18	Q4-18	Q1-19	Q2-19	Q3-19	Q4-19
EUR-USD	1.19	1.21	1.23	1.24	1.25	1.26
GBP-USD	1.32	1.32	1.32	1.33	1.35	1.36
GBP-EUR	1.11	1.09	1.07	1.07	1.08	1.08
EUR-GBP	0.90	0.92	0.93	0.93	0.93	0.93
USD-JPY	114	118	120	120	120	118
EUR-JPY	136	143	148	149	150	149
USD-CNY	6.65	6.70	6.80	6.70	6.70	6.70
EUR-CHF	1.15	1.20	1.22	1.23	1.24	1.24
USD-CHF	0.97	0.99	0.99	0.99	0.99	0.98
EUR-SEK	10.2	9.9	9.7	9.5	9.3	9.2
EUR-NOK	9.4	9.3	9.1	9.0	8.8	8.7
USD-CAD	1.24	1.22	1.22	1.20	1.20	1.19
AUD-USD	0.76	0.77	0.79	0.80	0.79	0.78
NZD-USD	0.68	0.69	0.71	0.72	0.73	0.74

Source: Santander

Euro interest rate forecasts

Government Bond yield Forecasts

Bunds	Current	3Q18	4Q18	1Q19	2Q19	3Q19	4Q19
ECB Refi	0.00	0.00	0.00	0.00	0.00	0.30	0.50
ECB Depo	-0.40	-0.40	-0.40	-0.40	-0.40	-0.20	0.00
3m	-0.57	-0.65	-0.60	-0.55	-0.40	-0.20	0.00
2y	-0.57	-0.45	-0.40	-0.20	0.00	0.20	0.45
5y	-0.18	0.05	0.05	0.30	0.55	0.75	0.95
10y	0.38	0.55	0.70	1.00	1.25	1.40	1.55
30y	1.05	1.10	1.35	1.55	1.70	1.85	2.00

Swap rate forecasts

€ swaps	Current	3Q18	4Q18	1Q19	2Q19	3Q19	4Q19
ECB Refi	0.00	0.00	0.00	0.00	0.00	0.30	0.50
ECB Depo	-0.40	-0.40	-0.40	-0.40	-0.40	-0.20	0.00
3m	-0.32	-0.33	-0.30	-0.28	-0.17	-0.01	0.22
2y	-0.15	0.00	0.00	0.15	0.30	0.50	0.75
5y	0.30	0.50	0.50	0.70	0.90	1.10	1.30
10y	0.90	1.00	1.15	1.40	1.60	1.75	1.90
30y	1.49	1.45	1.65	1.80	1.95	2.10	2.25

US interest rate forecasts

Government Bond yield Forecasts

USTs	Current	3Q18	4Q18	1Q19	2Q19	3Q19	4Q19
FOMC (mid)	1.875	2.125	2.375	2.625	2.875	2.875	2.875
3m	2.13	2.15	2.40	2.65	2.90	3.00	3.10
2y	2.65	2.80	3.05	3.25	3.40	3.50	3.60
5y	2.76	2.95	3.20	3.45	3.60	3.65	3.70
10y	2.90	3.05	3.25	3.45	3.60	3.70	3.80
30y	3.07	3.15	3.30	3.45	3.55	3.60	3.65

Swap rate forecasts

$ swaps	Current	3Q18	4Q18	1Q19	2Q19	3Q19	4Q19
FOMC (mid)	1.875	2.125	2.375	2.625	2.875	2.875	2.875
3m	2.32	2.55	2.75	2.95	3.15	3.20	3.25
2y	2.83	3.05	3.25	3.40	3.50	3.55	3.60
5y	2.89	3.05	3.25	3.45	3.55	3.55	3.60
10y	2.96	3.05	3.20	3.40	3.50	3.60	3.70
30y	3.00	3.05	3.20	3.35	3.40	3.45	3.50

UK Interest rate forecasts

Government Bond yield Forecasts

Gilts	Current	3Q18	4Q18	1Q19	2Q19	3Q19	4Q19
MPC	0.75	0.75	0.75	0.75	0.75	0.75	0.75
3m	0.79	0.71	0.70	0.65	0.70	0.71	0.75
2y	0.75	0.70	0.65	0.50	0.55	0.60	0.75
5y	1.05	1.00	0.90	1.00	1.20	1.50	1.60
10y	1.45	1.40	1.35	1.50	1.60	1.60	1.70
30y	1.81	1.70	1.75	1.80	1.90	2.00	2.00

Swap rate forecasts

£ swaps	Current	3Q18	4Q18	1Q19	2Q19	3Q19	4Q19
MPC	0.75	0.75	0.75	0.75	0.75	0.75	0.75
3m	0.80	0.81	0.80	0.80	0.80	0.81	0.83
2y	1.09	1.05	1.10	0.95	0.95	0.95	1.05
5y	1.33	1.30	1.25	1.30	1.45	1.70	1.80
10y	1.54	1.50	1.50	1.65	1.70	1.70	1.75
30y	1.65	1.50	1.60	1.60	1.70	1.70	1.70

FX forecasts

	Current	3Q18	4Q18	1Q19	2Q19	3Q19	4Q19
EUR-USD	1.162	1.19	1.21	1.23	1.24	1.25	1.26
EUR-GBP	0.898	0.90	0.92	0.93	0.93	0.93	0.93
GBP-USD	1.294	1.32	1.32	1.32	1.33	1.35	1.36
USD-JPY	111.3	114	118	120	120	120	118
EUR-JPY	129.3	136	143	147.6	148.8	150	149

	Current	3Q18	4Q18	1Q19	2Q19	3Q19	4Q19
NZD-USD	0.66	0.7	0.7	0.7	0.7	0.7	0.7
USD-CAD	1.318	1.24	1.22	1.22	1.20	1.20	1.19
AUD-USD	0.72	0.8	0.8	0.8	0.8	0.8	0.8
EUR-CHF	1.126	1.15	1.20	1.22	1.23	1.24	1.24
EUR-SEK	10.58	10.2	9.9	9.7	9.5	9.3	9.2
EUR-NOK	9.77	9.4	9.3	9.1	9.0	8.8	8.7

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

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

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

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