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Interest & Exchange

Are we there yet?

Global Strategy: We continue to believe that despite all the ongoing uncertainties, the pace of normalisation of EUR official rates in 4Q19-2021 will be a touch faster than currently priced in by the forwards, but also quicker than what the ECB is currently implying. This is contrary to the Federal Reserve, where we believe they will not be able to raise rates as much / as fast as their own projections show.

US Macro: Since the beginning of 2018 the US administration has taken actions related to fiscal and trade policy. These tax cuts have fuelled consumer and business sentiment and have so far had a very positive impact on investments, whose effect could continue to be felt until at least the end of 2018. However, these positive effects might be offset by a likely increase in import prices derived from the application of tariffs. In the case of Chinese imports, the impact would be especially negative on the industrial front.

US Rates: The repricing of monetary policy expectations has finally made the market move towards our forecasts and we opt to close our strategic front-end shorts, taking profits. We remain bearish and expect higher US rates all along the curve, but prefer to express our strategic views through more relative-value carry-efficient positions (such as 5s10s flatteners).

EUR Macro: French GDP disappointed in 1H18 with a quarterly growth rate of 0.2%, certainly much lower than those seen in previous quarters. 2017 GDP growth was the strongest since 2007 and 2018 is also likely to disappoint. However, we see better numbers in 2H18 onwards. Some one-offs and special factors played a key role in 1H18 but are not likely to be repeated in coming quarters. In the end, 2019 could exceed 2018 GDP growth.

EUR Rates: There are still headwinds to higher EUR rates but the policy trend and large lag vs. US rates point upwards. Italian spreads are likely to remain volatile, making outright BTPs a poor risk-reward proposition. We look for a steeper spread term structure as near-term credit risk looks overstated. SPGBs offer a strong mix of yield pick-up and moderate fundamental risk and we remain overweight.

GBP Macro and Rates: The Brexit process grinds on slowly and noisily, with the Irish backstop proving as difficult as we feared. But the market has increasingly looked through dramatic headlines, and UK rates have largely followed September's sell-off in USTs. We still expect a Withdrawal Agreement to be concluded by November, but for that to be far from the end of Brexit uncertainty. UK term rates are likely to continue drifting higher along with those in the US, regardless of the ongoing political confusion.

G-10 FX: The USD remains firm, bolstered by low risk appetite, higher US yields and good US economic data, but the currency is still off of its August high. Meanwhile, concerns over Italy's 2019 budget continue to weigh on the EUR, despite the ECB adopting a less pessimistic stance at the September meeting. Finally, we still feel that the pound should remain vulnerable, given Brexit/political uncertainty over the coming weeks.

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

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

	USD	EUR	GBP
Economic Outlook	We have revised our GDP estimates for 2018 to 2.8% YoY (from 2.5%) and to 2.7% in 2019 (vs 2.6%) after including the effect of the fiscal reform. We expect a higher fiscal deficit and worse c/a balance	1H18 GDP growth rates have surprised to the downside. Special one-off factors and global uncertainty would be behind that performance. We believe that c.2.0% GDP growth rates are still valid for the area and internal demand should perform well in the coming quarters.	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 growth & inflation data, plus rising Brexit risks, likely to frustrate the MPC's tightening bias.
Rates / Duration	The monetary policy normalisation, healthy macro environment and potential changes in the supply/demand equilibrium should weigh on USTs all along the curve.	The bearish trend remains quite moderate. It should gradually accelerate as ECB policy begins to tighten and the lag vs. US rates generates outflows from core EGBs.	We see September's sell-off as driven by the US market (e.g. 10y UKT-UST unchanged), and expect the UK to continue shadowing that bearish trend regardless of Brexit noise.
Curve / Slope	With our strategic front-end shorts now reaching our target, we recommend switching into 5s10s flatteners as a carry-efficient proxy for outright shorts.	Overall steepness has been highly directional. Relative to short-term statistical relationships, the 15y area looks rich but, as rates rise, the curve will flatten further.	Ultra-short and ultra-long gilts look relatively cheap (<3y and >30y). 10y's premium persists despite the outright sell-off and improved liquidity.
Spreads	Gradually unwinding SOMA reinvestments pose a risk for USTs. We like swap spread wideners (bearish USTs), especially at the ultra-long end.	Concerns over Italian fiscal policy have pushed spreads higher again. Although implied default probabilities seem high to us, we prefer BTP-Bund box steepeners to outright trades. Spanish fundamentals suggest o/performance.	Brexit and EM concerns justify wide gilt ASW. 6-7y still looks relatively tight. Ultra-longs have tightened ahead of October's 71s sale, 40y particularly appeals.
Volatility	We find the top left corner cheap and the 5y5y area and the vega in most tenors a little rich, both compared to delivered and recent ranges.	The 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 have bounced back from a trough in mid-September, but we still see them as having further ago to fully reflect two-way Brexit tail risks.
Inflation / Break-evens	Synthetic "real" rates look low in the swap universe, particularly in the 2y area. However, cash breakevens remain attractive at the front end, especially when compared to the YtD increase in core CPI.	Market-traded Euro area inflation levels are below summer's highs. They are likely to edge higher but at a slow pace. In RV terms, the new SPGB€i Nov-2033 is a cheap issue.	It remains to be seen whether recent upside surprises in spot inflation and wage growth can persist. Front-end breakevens have widened unsustainably sharply.
FX	The USD remains firm. Political and trade concerns may still have an impact but the mix of a strong economy and further Fed rate hikes should provide support going forward.	Eurozone risks are again weighing on the EUR. However, a firm economy, higher inflation and a less pessimistic ECB should caution against over-selling.	The pound remains vulnerable to slower GDP, CPI and political uncertainty. We do not expect the BoE to hike rates until 2020. If a Brexit withdrawal agreement is reached in November, the pound should rally.

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 +112bp. Target +70bp. **2) BTP-Bund 7y20y (2025-2037) box spread 'steepening'** at -13bp. Target +20bp.	**1) Buy the belly of a UKT 5s7s10s fly.** Current level = -12bp. Target = -15bp. Stop Loss = -10bp. **2) UKT 30s40s flattener.** Current level = -8bp, Target = -13bp. Stop Loss = -7bp.
Rates	**1) Pay 2y swaps vs. IL** Entry spread = 0.72%. Target = 0.85%. Stop Loss = 0.68% **2) 5s10s flatteners in swaps** Entry = 7bp. Target = 0bp. SL=10bp	**1) EUR 5s30s 'bearish' flattener** at -116bp. Target 106bp **2) Pay 10y Euribor fixed, receive 10y ILS** at -0.60%. Target -0.45%	**GBP 2s10s steepener.** Entry level = 47bp.Target = 60bp. Stop Loss = 44bp
FX	**Sell USD/CAD** originally at 1.3050 (31 August 2018) target= 1.27, with a stop loss at 1.3250	**Buy EUR/CHF** at 1.1385. Target = 1.1700. SL = 1.1180.	**Sell GBP/NOK** originally at 10.75 (27 July 2018), target = 10.20, with a stop loss at 11.025

Global Strategy: Are we there yet?

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- **We continue to believe that despite all the ongoing uncertainties, the pace of normalisation of EUR official rates in 4Q19-2021 will be a touch faster than currently priced in, but also quicker than what the ECB is currently saying. This is contrary to the Federal Reserve, where we believe they will not be able to raise rates as much / as fast as their own projections show.**

Heightened Macro & Political Uncertainty

Since our last issue four weeks ago, the global macro environment has not changed much but, in our view, the outlook continues to turn gradually more uncertain, slowly increasing the chances of an economic slowdown in the coming quarters. And that is despite the fact that we believe the inversion of the US slope is not necessarily an omen of an immediate recession.

As discussed two months ago, we believe that the relationship between curve inversion and subsequent economic recessions in the US remains valid, but the global search for yield has artificially flattened the US yield curve, biasing the analysis of how close is the US economy from entering a significant economic deceleration. But there are other signals pointing to a slowdown in most advanced economies, heightened by the uncertainty of key geopolitical events globally, from the tariff war to Brexit, EM crises or Brazilian elections.

A similar concern was expressed by the OECD in its recent Interim Economic Outlook as, according to their numbers, the global expansion 'has peaked'. That said, even before the recent fiscal boost, monetary policy had already made the present economic cycle one of the longest in decades. And, at 3.7% in 2018 and 2019, the OECD still forecasts a decent level of growth, albeit marginally below pre-crisis levels.

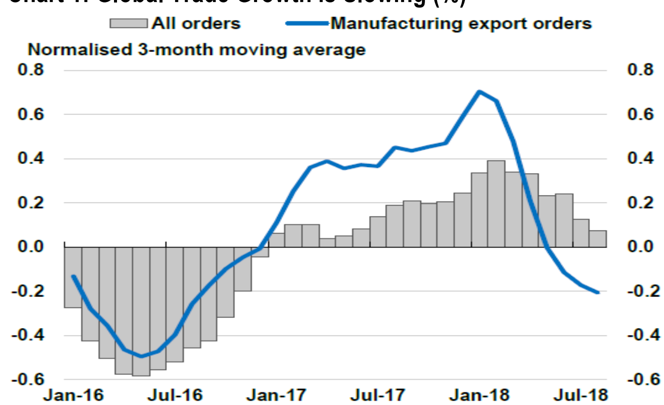
As seen in Table 1, not only the OECD has revised downwards most advanced economies' growth projections, but basically none of these countries is expected to see its growth accelerating in 2019 vs. this year, with next year's growth expected to be between 0.5% and 0.7% below 2017, if we leave the fiscal-boosted US economy aside.

Table 1: OECD GDP forecasts (and changes vs. May 2018, %)

	2017	2018	Chg	2019	Chg
World	**3.6**	**3.7**	**-0.1**	**3.7**	**-0.2**
G20	**3.8**	**3.9**	**-0.1**	**3.8**	**-0.3**
US	2.2	2.9	**0.0**	2.7	**-0.1**
Euro area	2.0	2.0	**-0.2**	1.9	**-0.2**
Germany	2.5	1.9	**-0.2**	1.8	**-0.3**
France	2.3	1.6	**-0.3**	1.8	**-0.1**
Italy	1.6	1.2	**-0.2**	1.1	**0.0**
Japan	1.7	1.2	**0.0**	1.2	**0.0**
United Kingdom	1.7	1.3	**-0.1**	1.2	**-0.1**

Source: Santander, OECD

Chart 1: Global Trade Growth is Slowing (%)



Source: OECD

The qualitative aspects are also worrisome, as it seems increasingly clear that global trade tensions and related uncertainty are starting to have adverse effects on confidence and investment plans, especially in some sectors and countries (Chart 1). This potential disruption to global supply chains should also have noticeable adverse effects on investment around the globe and, eventually, on supply-side inflation.

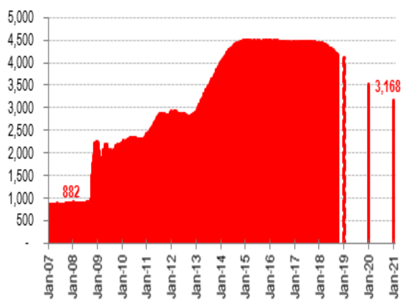
Besides the OECD and the consensus, the IMF is also expected to shave its 3.9% global GDP growth forecast for this year and the next when it publishes its new macro projections next week. We will keep an eye on next year's figure for China as well as the forecasts for US growth in 2020 and 2021.

In this regard, the recently released [Federal Reserve Board Members' Economic Projections] show an economy losing substantial momentum once the bulk of the effect of the TC&JA is behind, with GDP growth expected to decelerate sequentially from 3% this year to 2.5%, 2.0% and 1.8% in the following three years, respectively. This economic slowdown amid significant – and rising - macro and geopolitical uncertainty is the main reason why we have argued for some time that, despite the present good health of the US economy and expected further – mild – acceleration in inflation and wages, **we think the Fed should be cautious in its present tightening process**.

Fed wise, we think that, rather than building a (monetary) buffer so as to be able to cut rates if needed, it is better to try to avoid that hard landing.

And we cannot ignore the fact that the Fed is also shrinking the size of its balance sheet (-$330bn to $4.19trn so far, Chart 2). And from this week the Fed will increase the amount of non-reinvested redemptions in its portfolio to its highest level: $30bn and $20bn per month in USTs and agency MBS.

Chart 2: US GDP growth and FOMC forecasts



Source: Santander, Federal Reserve

Be careful what you wish for

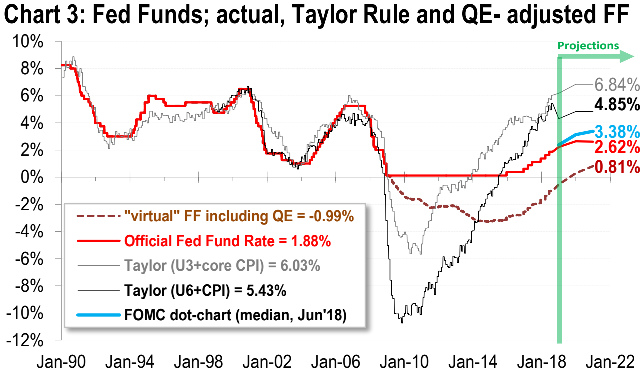
As regards the FOMC, we maintain our long-held call for a total of four Fed hikes in 2018 (one more to go), **followed by just one-two more in 2019,** i.e. basically three less the Fed's own dot plot median. We have spent most of this year between the FOMC and the market regarding our monetary policy expectations, but the market has recently caught up more with our view. At the time of writing, Jun'19 Fed Funds futures trade at 2.64% (+100bp in the last 12 months) vs. 2.0% at the start of the year.

We think it will be a combination of the fiscal stimulus losing steam and the consequences of the above-described global uncertainty that **will eventually make the Fed to take a break in its hiking cycle by mid-2019.**

Moreover, we are not incorporating into our expectations a possible full-blown trade war, a collapse in EM markets or a Chinese hard landing, although we acknowledge that the potential split in the House between Republicans and Democrats could have implications for potential infrastructure spending plans, and therefore for economic growth, in the second half of this term

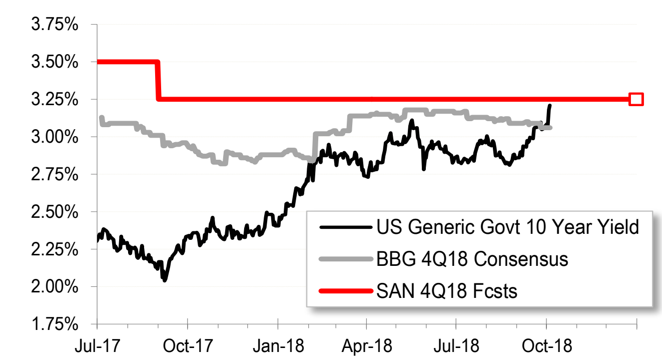
All of this in an environment where the Fed has already started to recognise that monetary conditions are no longer 'accommodative', although we beg to respectfully disagree. If we take the massive increase in the Fed's balance sheet since 2009, our QE-adjusted Fed Funds rate is still c.0% (Chart 3), i.e. a level that can be considered accommodative, in an environment where the Fed has already fulfilled its dual mandate, even acknowledging the lower r* in this cycle. **But we see no need to take Fed Funds above the 2.75%-3.0% level that most Fed members consider to be neutral for the long term**.

Chart 3: Fed Funds; actual, Taylor Rule and QE- adjusted FF



Source: Bloomberg, Santander

Chart 4: SAN Forecast for US 10y rates vs Actual & Consensus



Source: Santander

Regarding the US curve long end, we continue to believe the above-mentioned macro outlook and monetary normalisation will help to drive long-term rates higher, pushed by a fast-increasing supply of bills and bonds. **We maintain our long-held call for US 10y Treasury yields at 3.25%** by year-end. As seen in Chart 4, we have maintained our forecast for over a year now and it has been the market (and the consensus) that have approached it.

ECB: Faster, but Forward

Central bank watching seems less interesting in the Euro area, at least in the near future, as the bar seems too high for the ECB to deviate from the commonly-held view that its first move in official rates will not take place before September 2019. But as argued in the past, and despite the possible reasons for the ECB to avoid talking about rate hikes at this stage (core inflation, downward growth revisions, effective euro exchange rate, or even politics), **time-wise**, we think that by the middle of next year the macro situation in the Euro area will be solid enough for the ECB to start slowly normalising official rates. And despite some small downward revisions in its latest Staff Macro Projections, the ECB also seems to believe that will be the case.

(*) Forward guidance and policy normalisation, Speech by Benoît Cœuré, Member of the Executive Board of the ECB, at the DIW, 17 September 2018

Regarding the **pace** of this normalisation, EUR short-term rates have been very volatile recently, being pulled on the one hand by some ECB members' comments ("significantly stronger core inflation"), but pushed by political uncertainty, mainly in Italy. EONIA 1y1y rates, for instance, rose from -21bp to -9bp, to fall back again to -13bp, while ERZ0 increased from 14bp to 35bp, to lose some steam afterwards towards the high 20s level.

However, as argued in depth last month, the ECB has no incentive to scare markets at this stage. In this regard, we found the Taylor rule analysis presented by **Benoit Coeuré** last month in a speech (*) very 'interesting'.

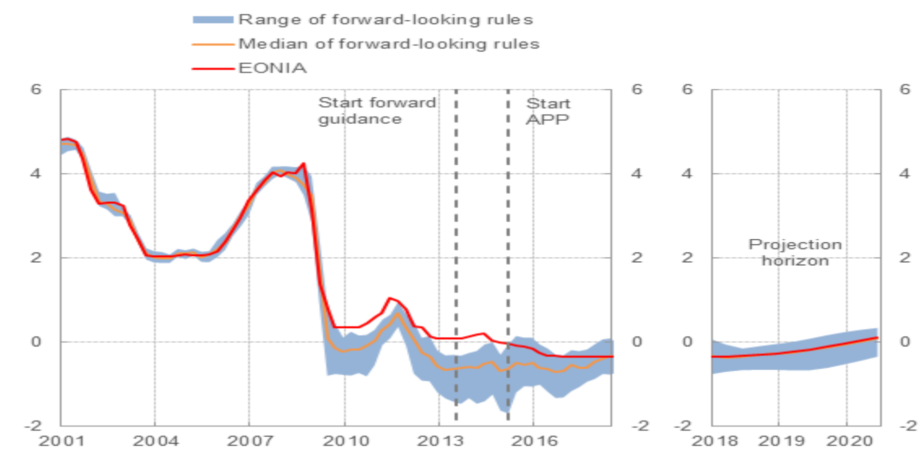
His estimate of neutral rates (Chart 5) shows how short-term rates should have been negative (and clearly below actual rates) for most of the 2010-2017 period, hence indicating the necessity of non-conventional measures (TLTROs and asset purchases). That said, from the chart we can also infer that the ECB should have lowered rates faster (and further) and avoided the two 2011 hikes

Table 2: EONIA market-implied expectations

ECB Meeting date	fwd Eonia	Probability of 10bp changes				
		0	1	2	3	4
Oct 25, 2018	-0.35%	90%	10%	-	-	-
Dec 13, 2018	-0.35%	90%	10%	-	-	-
Jan 24, 2019	-0.35%	90%	10%	-	-	-
Mar 07, 2019	-0.35%	90%	10%	-	-	-
Apr 10, 2019	-0.34%	80%	20%	-	-	-
Jun 06, 2019	-0.33%	70%	30%	-	-	-
Jul 25, 2019	-0.31%	50%	50%	-	-	-
Sep 12, 2019	-0.31%	50%	50%	-	-	-
Oct 24, 2019	-0.25%	-	90%	10%	-	-
Dec 12, 2019	-0.20%	-	40%	60%	-	-
Jan 23, 2020	-0.17%	-	10%	90%	-	-
Mar 05, 2020	-0.11%	-	-	50%	50%	-
Apr 08, 2020	-0.07%	-	-	10%	90%	-
Jun 04, 2020	-0.05%	-	-	-	90%	10%
Jul 23, 2020	-0.03%	-	-	-	70%	30%

Source: Santander

Chart 5: ECB Taylor-type policy rule prescriptions for the Euro Area (%)



Source: EC, ECB

What really puzzles us is how, incorporating the ECB own macro forecasts that are normally the inputs for any Taylor rule estimate, namely a below-NAIRU unemployment rate (7.4% expected in 2021) and a core measure of inflation rate at its target (1.8% in 2021), this Taylor estimate seems still consistent with current market pricing for official rates, with in fact a downside bias given the range of forward-looking rules in the chart.

Given the ECB's (and our own) macro projections for coming years, we continue to believe that despite all the uncertainties mentioned above, the pace of official rates normalisation in 4Q19-2021 will not be only a touch faster than currently priced in (see Table 2), but also quicker than what the ECB is currently saying. This would be contrary to the Federal Reserve, where we believe they will not be able to raise rates as much / as fast as their own projections show.

US Economic Outlook

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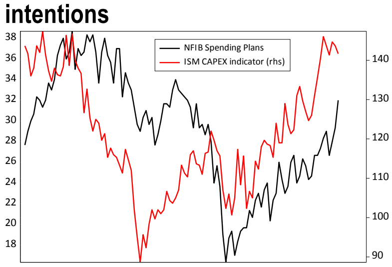
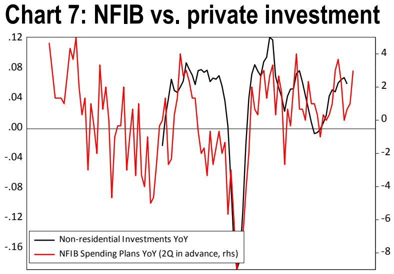
2Q18 GDP figures showed a significant acceleration of the US economy after the modest growth posted in 1Q18. The fiscal package brought in by the government seems to be already having a significant impact on economic growth. Internal demand is doing quite well, driven by both investment and private consumption. 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 6: Companies' investment intentions



Source: NFIB, ISM, Santander.

Chart 7: NFIB vs. private investment



Source: NFIB, BEA, Santander.

Tax reform and tariffs could have opposing effects on the US economy

The best known actions of Mr Trump's administration so far have been the measures taken in the fiscal and trade areas. However, uncertainties are starting to arise regarding the combined impact of both sets of measures in the coming quarters. On the one hand, it seems that the tax cuts are already fuelling companies' confidence and plans to invest but on the other hand the rise in tariffs could negatively affect corporate margins through higher import and production prices. Here we try to assess the net effect of these regulatory changes on the US economy.

Tax reform set to foster investment and consumption…

In December 2017, Mr Trump's administration signed into law the "Tax Cuts and Jobs Act".

In the case of corporates, the most relevant points of the reform are: 1) the reduction in the corporate tax rate from 35% to 21%; 2) the establishment of provisions to enable companies to immediately expense 100% of the amount they intend to spend on investments over the following five years; and 3) the reduction of the tax rate applied to tax-deferred foreign earnings to 15.5% in the case of liquid assets and 8% in the case of illiquid assets vs. the former 35% tax on earnings generated abroad. According to the US administration, these measures should lead to cash generation over the next 10 years of $1.125bn in the case of small and medium-sized companies and of $320bn in the case of large corporations.

In the case of households, it is worth highlighting the following: 1) the reduction of between 1% and 2.5% of the tax rate applicable to each income bracket; 2) the simplification of the system of deductions, leading to an average increase in deductions to twice the former amount and savings from an administrative point of view and, as a counterbalance; 3) the lowering of the cap on mortgage interest payments subject to deduction from $1mn to $750K.

These measures aim to fuel investment and consumption and the charts on the left show that the components of business sentiment indices related to the intention to increase capex have generally been improving since 2009. However, the "spending plans" component of the NFIB, related to small and medium-sized companies and hence to the domestic economy, has accelerated significantly since the beginning of 2018, while the capex indicator of the ISM Manufacturing index (related to larger corporations that tend to have stronger exporting activity) already started to rise at the beginning of 2016, when global demand began to grow. In any case, both indicators (NFIB spending intentions and capex of the ISM) anticipate some recovery in investment in production capacity.

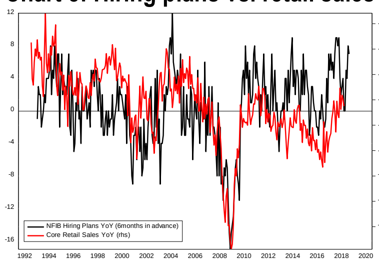
The improvement in business conditions suggested by the NFIB since the beginning of 2018, coinciding with the implementation of the fiscal reform, is also likely to have a positive impact on consumption. Note that the rise in the hiring plans indicator of the NFIB points towards an acceleration of core retail sales until the end of 1Q19.

Moreover, it seems that we have not yet seen the full impact of the fiscal reform on US growth and we could expect some acceleration in investments and domestic personal consumption expenditure at least until the end of 1H19.

…but these positive effects could be partially offset by the impact of trade tariffs…

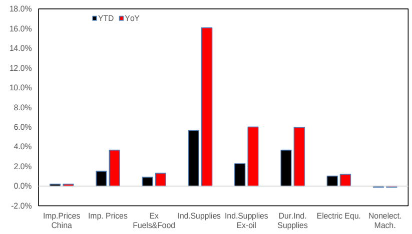
Since the beginning of 2018, the US administration has been increasing the tariffs applied to imports, especially to those coming from China. Note that

Chart 8: Hiring plans vs. retail sales



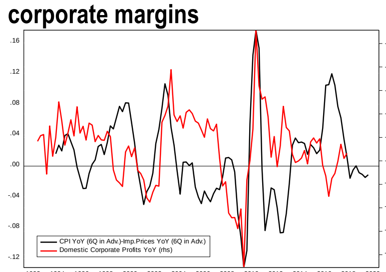
Source: NFIB, US Census Bureau, Santander.

Chart 9: Import prices of the US



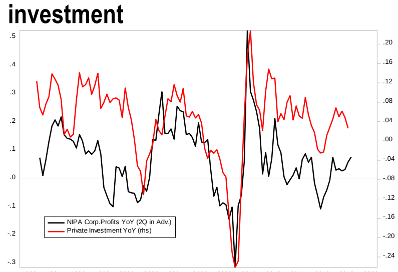
Source: BLS, Santander.

Chart 10: CPI-import prices vs. corporate margins



Source: BLS, BEA, Santander.

Chart 11: Corp. profits vs. private investment



Source: BEA, Santander.

China accounted for 21.8% of the US's total imports in 2017 and it is the main source of US imports after NAFTA, which accounted for 25.9% of the US total in 2017. The US's main imports from China are electrical machinery and equipment (28.5% of the imports from China) and mechanical machinery (21.36% of the imports).

The tariffs imposed on Chinese imports so far apply to $200bn of the $526bn worth imported by the US from China in 2017 and imply an extra cost of $32.5bn (+16.25% vs. the volume reported in 2017). Note that according to the Census Bureau numbers, since the end of 2017, imports from China have risen by 15.9% vs. the 16.25% increase derived from the new tariffs, so the impact in terms of volumes of the tariff hike is close to zero.

However, corporates are already warning of the possibility of a negative impact on margins that could lead to investments being delayed or even cancelled if the US effectively implements its plans to increase tariffs to 25% on imports from China worth USD250bn from 1 January 2019, with the possibility of a 25% burden on imported goods worth $267bn later on.

…affecting corporate margins

Based on data up to the end of August, import prices have risen by 1.5% since the end of 2017 (by 0.9% if we exclude oil imports), while the price of imports from China has increased by just 0.2%. The main reason for the only slight rise in import prices (ex-oil) is the 0.1% YTD dip in the non-electrical machinery component that accounts for 21.4% of US's imports from China (and Chinese imports of these items account for 32% of the total US's non-electrical machinery imports). Moreover, the price of electrical equipment imports (28.5% of the total imports from China and 42% of the US imports of these items) has risen by only 1.0% YTD. Note also that if we adjust import prices by the USD strength index (DXY), global import prices and those of the imports of goods coming from China follow practically the same pace. This means that 1) the impact of the tariff increases has been quite tame; and 2) import prices ex oil are contained in any event, probably because of the USD's strength, and this is surely helping US corporate margins. In fact, the increase in import prices in the current context of contained CPI is likely to put pressure on corporate margins generated domestically, which in NIPA terms represent 74.5% of corporate profits.

NIPA corporate profits tend to anticipate by two quarters the trend of private investments and their performance is expected to be favourable at least until the end of 2018, to some extent because of the fiscal reform. However, the proxy of margins that we have analysed, CPI – import prices, shows a negative yearly trend in corporate profits by 2020 and this could prompt a slowdown in investments and hence in GDP by then.

To sum up:

- The "Tax Cuts and Jobs Act" is having a very positive impact on consumer and corporate confidence that could take growth in non-residential investments to rates close to 8.0% YoY by the end of 2018 vs. the current 5.9% YoY.
- The average rise in the price of imports from China of 16% since the beginning of 2018 has had no impact so far on import volumes and/or corporate margins. However, if all the tariff increases are applied in line with the announcements made by Mr Trump, the trend of the yearly growth rates of domestic corporate profits might level off significantly during 2020.
- In the case of the tariffs applied to Chinese imports, the negative effect would be concentrated on the industrial sector, since the US's imports of electrical and non-electrical machinery from China total almost 40% of the US imports of these items.

US Rates Strategy: Approaching our targets

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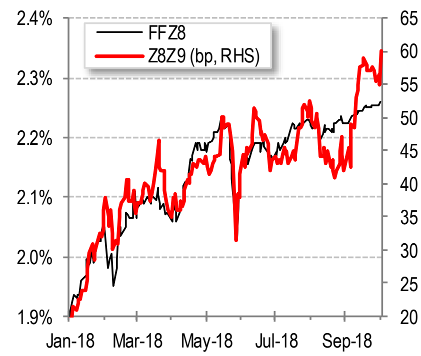
Chart 12: YtD evolution of monetary policy expectations – as measured by FF futures



Source: Bloomberg, Santander.

- **We see the outcome of the September FOMC meeting as a reaffirmation of our expectations of another hike being delivered in December, but we still think the Fed might finally opt to take a break in the normalisation process once the neutral rate is reached (in 2019).**
- **That continues to place us in a more dovish position than the FOMC dots but more hawkish than the market, although after the recent price action market expectations have moved significantly towards our view, especially for 2018 and 2019.**
- **As a result, we are closing our strategic front-end shorts, taking profits. We remain bearish and expect higher US rates all along the curve, but we prefer to express our strategic views through more relative-value carry-efficient positions (such as 5s10s flatteners).**

Front-end rates are approaching our targets. Further gains in strategic front-end shorts start to look limited…

The repricing of monetary policy expectations that occurred during September (see Chart 12), finally confirmed by the FOMC decision last week, has brought the 2y2y USD swap rate - one of our strategic trades for this year - to our target. Since we recommended paying that fixed rate back in December (see our Year-Ahead Report), it has increased by around 100bp. As our regular readers might recall, we have closely monitored the evolution of this rate throughout the year, lifting our target on several occasions (see our 2 February I&E and our 22 March MMD, for instance) as we approached our prior target levels. Now it is time to reassess our views again.

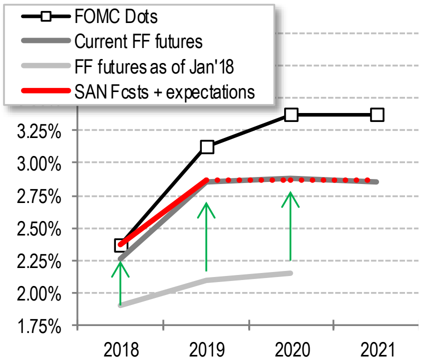
In this regard, the information provided by the Fed in the September FOMC offers, in our view, quite significant insight into the main concerns and possible decisions to be announced in the next few quarters, as we discussed in our FOMC post-mortem, included in our 27 September MMD.

On the hawkish side, we would highlight that there is an ample majority of members now favouring another hike before the end of the year (12 out of 16), probably encouraged by the upward revisions to the 2018 and 2019 GDP forecasts. Also, the "longer-run" dots (usually seen as a proxy for the "neutral" FF rate) were revised upwards slightly and their median now stands at 3.00%. These are clear signs suggesting that the Fed feels confident about the improvement in economic growth and, therefore, comfortable with continuing the pace of normalisation delivered so far (quarterly 25bp hikes), at least for the next few meetings.

On the other hand, the newly introduced 2021 projections provide fresh arguments to the dovish camp to remain cautious. The GDP and unemployment projections suggest that the fiscal-easing boost might fade away by that year, as GDP growth is expected to decline from 2.0% in 2020 to 1.8% in 2021 and the unemployment rate to rise again from 3.5% to 3.7%. This probably supports the FOMC view of no extra hikes in 2021 depicted in the dot chart.

As a result, we see the outcome of this latest FOMC meeting as a reaffirmation of our expectations of another hike being delivered in December, but we still think the Fed might finally opt to take a break in the normalisation once the neutral rate is reached (in 2019), before continuing with a slight tightening in 2020 if the macro situation remains as solid as currently expected. That continues to place us in a more dovish position than the FOMC dots but more hawkish than the market, although after the recent price action market expectations have moved significantly towards our view, especially for 2018 and 2019 (see Chart 13).

Chart 13: Current monetary policy expectations – FOMC dots vs. FF futures vs SAN



Source: Bloomberg, Santander.

This has direct implications for our call on the 2y2y USD swap rate. Every time we have updated our target for this trade, the revision was based on its historical regression vs. the FFZ9 future (see Chart 15). With that contract already trading at the levels we consider appropriate, we see very limited gains in paying the 2y2y at these levels. We would only recommend entering now to those investors firmly convinced that the Fed will deliver as many hikes as depicted in the dot chart (see Chart 16) but, from a strategic point of view, we think this is the right time to close the position and take profits, after having moved c.100bp in our favour.

Close trade idea: Pay the 2y2y in USD swaps @ 3.30%

Original entry level = 2.30%. Last revised target = 3.30%

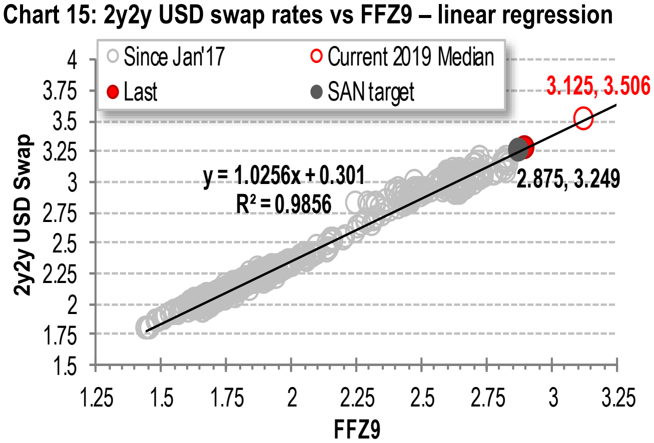
This trade was one of our strategic recommendations for 2018 and has performed even better than initially expected, leading us to extend the target from the original 2.70% level proposed in our Year-Ahead I&E to a revised 3.30% in our 22 March MMD.

Now, with the FF curve finally moving towards our monetary policy expectations, we think that room for further gains is starting to look limited and prefer to take profits here.

Chart 14: Our 2y2y strategic trade has just reached our target

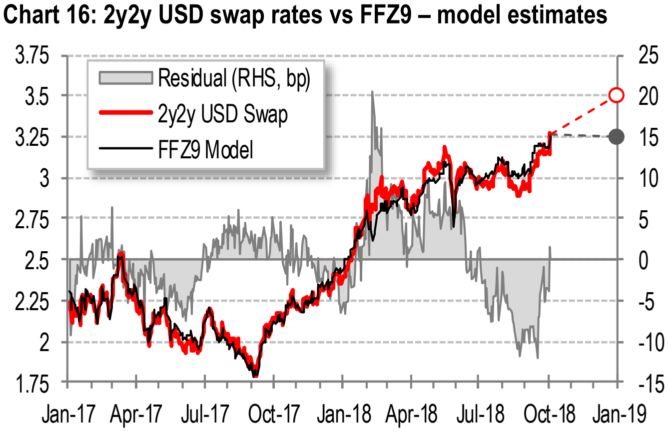
Source: Bloomberg, Santander.

Chart 15: 2y2y USD swap rates vs FFZ9 – linear regression



Source: Bloomberg, Santander.

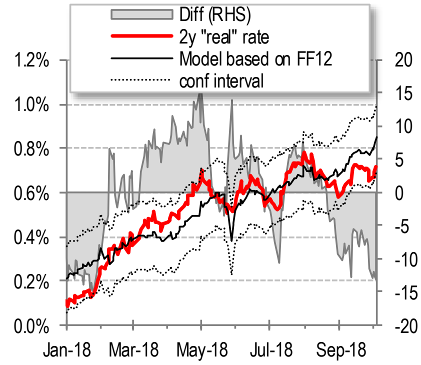
Chart 16: 2y2y USD swap rates vs FFZ9 – model estimates



Source: Bloomberg, Santander.

…although that part of the curve still looks <u>tactically</u> attractive compared to the belly and the long end…

Chart 17: 2y "real" rates still have to catch up with the recent repricing in FF futures



Source: Bloomberg, Santander.

Having said that, we continue to find the front end of the curve (up to the 7y tenor) too low compared to the recent performance of IL swaps and FF futures (see Chart 18, next page). As we have explained in previous editions of this report, this kind of analysis has proved effective throughout the year to identify possible dislocations that can lead to tactical trades in the USD swap curve, and based on this we have suggested some successful trade ideas such as the 2s7s10s fly recommended [last month](), which is already in the money.

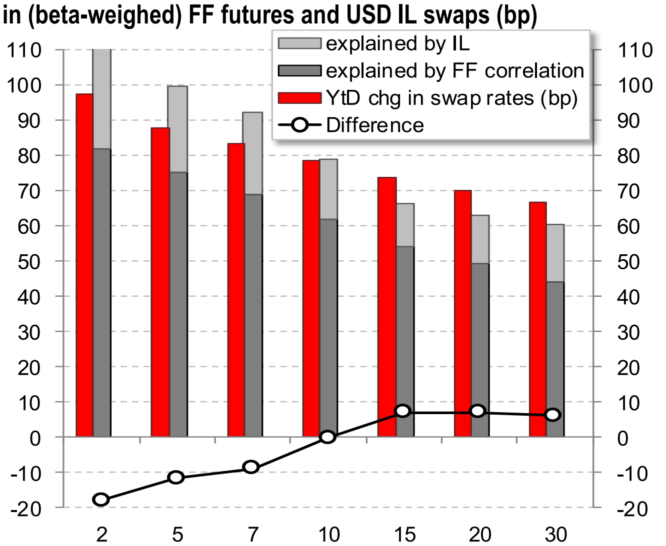
This analysis now suggests that the 2y swap rate is around 15bp lower that what would be consistent with the recent repricing in FF futures and 2y IL swaps (see Chart 17, next page). Indeed, statistical models based on the historical correlation ($R2=82.6\%$) between synthetic 2y "real" rates (measured as the difference between Libor swaps and IL swaps in the US) and the FF12 contract suggest that the spread between the 2y USD swap rate and the 2y USD IL swap rate could still widen by around 15bp (Chart 16).

<u>Trade idea:</u> Pay fixed in 2y USD swaps vs. 2y IL swaps

Entry level = 0.72%. Target = 0.85%. Stop-loss = 0.68%

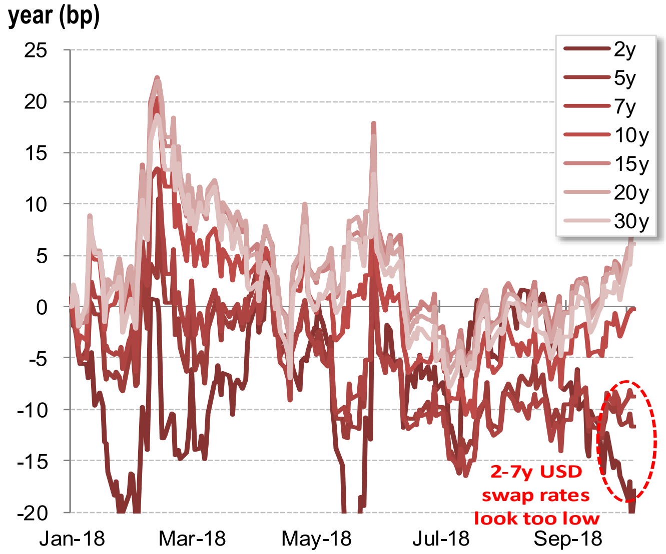
We target an initial increase to the 85bp level suggested by our model as consistent with current FF12 levels. As time goes by and the FF12 rolls into longer expiries, if they meet our expectations of FF hikes described at the beginning of this section, the regression model suggests that the 2y "real" rate could even increase to the 0.90% area, and thus we will reassess our recommendation if/when the initial 0.85% target is reached

Chart 18: Dislocations in USD swap rates based on YtD changes in (beta-weighed) FF futures and USD IL swaps (bp)



Source: Bloomberg, Santander.

Chart 19: Historical evolution of those dislocations through the year (bp)



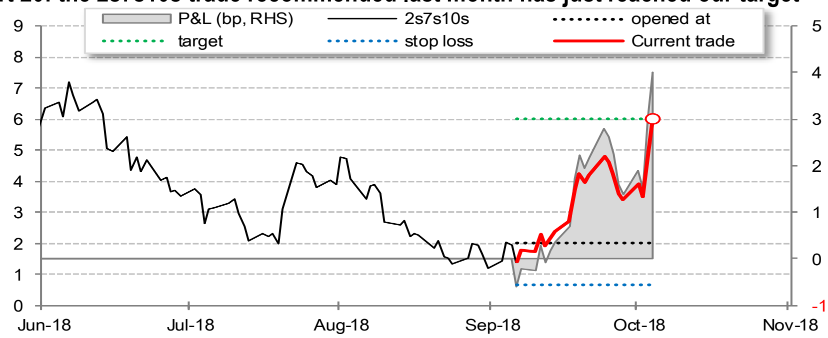
Source: Bloomberg, Santander.

Also, we are closing with profits our 2s7s10s trade, recommended [last month](). As shown in Chart 20, it has already reached our proposed target and Chart 18 suggests that, in light of the latest price action, the 7y no longer looks cheaper than the 2y and the 10y, so we take profits here.

<u>Close trade idea:</u> Pay the belly in 2s7s10s in USD swaps @ 6bp

Entry level = 2bp. Target = 6bp

Chart 20: the 2s7s10s trade recommended last month has just reached our target



Source: Bloomberg, Santander.

…so, we recommend switching from front-end shorts into 5s10s flatteners as our preferred strategic positioning for the rest of the year.

However, we are aware that the negative carry of being short the front end of the USD swap curve is highly punitive and, therefore, we prefer to express any tactical view though positions that at least minimise that carry.

Specifically, we look for positions that benefit from the dislocations found in <7y tenors, which continue to have some exposure to higher FF rates (in order to capture the benefit from the current cycle, as well as any hawkish market reaction) and that minimise the cost of carry. And 5s10s flatteners in USD swap rates seem a quite attractive choice, based on those parameters.

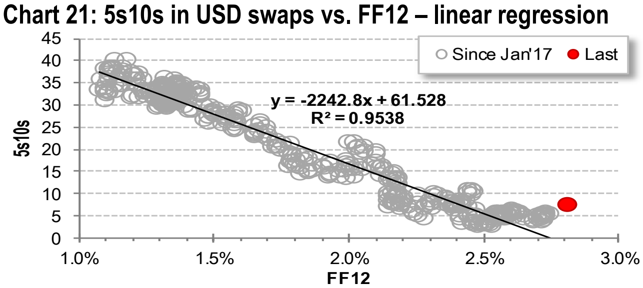
As shown in Chart 21, the 5s10s slope has maintained a very high correlation with FF12 futures (R2=95.4%) and is currently around 5bp steeper than what would be statistically consistent with the current FF12 levels (Chart 22). Furthermore, as time goes by and the Fed continues with its normalisation, the rolling FF12 future will continue to price higher rates, which should translate into some extra flattening if this historical relationship remains in force. Finally, the combined carry and roll-down is negative (-1.7bp in three months), but certainly less punitive than outright shorts on the 2y (-11.5bp in three months).

<u>Trade idea:</u> 5s10s flatteners in USD swaps

Entry level = 7bp. Target = 0bp. Stop-loss = 10bp
3m carry = -1.6bp 3m roll = -0.1bp

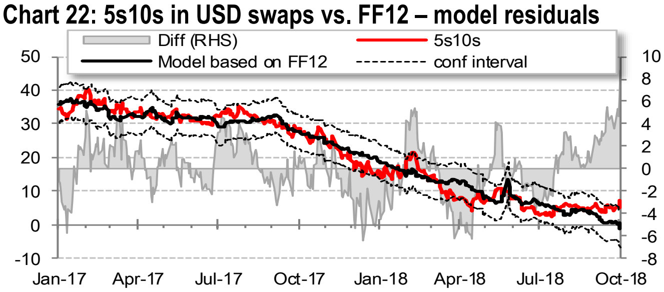
We suggest entering this trade now, initially targeting the 0bp area, which would be consistent with the current level of the FF12 future. As time goes by and the FF12 rolls into longer expiries, if they meet our expectations of FF hikes described at the beginning of this section, the regression model suggests that the 5s10s slope could even decline to -5bp as we approach 2019, and thus we will reassess our recommendation if/when the initial 0bp target is reached.

Chart 21: 5s10s in USD swaps vs. FF12 – linear regression



Source: Bloomberg, Santander.

Chart 22: 5s10s in USD swaps vs. FF12 – model residuals



Source: Bloomberg, Santander.

Eurozone Economic Outlook

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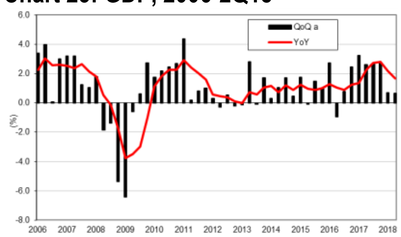
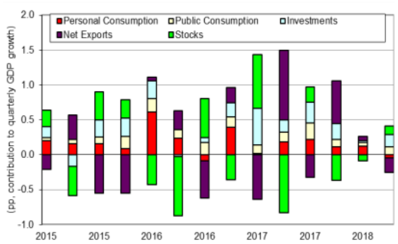
French GDP disappointed in 1H18 with a quarterly growth rate of 0.2%, certainly much lower than those seen in previous quarters. 2017 GDP growth was the strongest since 2007 and 2018E is also likely to disappoint. However, we see better numbers in 2H18E onwards. Some one-offs and special factors played a key role in 1H18 but are not likely to be repeated in coming quarters. In the end, 2019E could exceed 2018E GDP growth.

Chart 23: GDP, 2006-2Q18



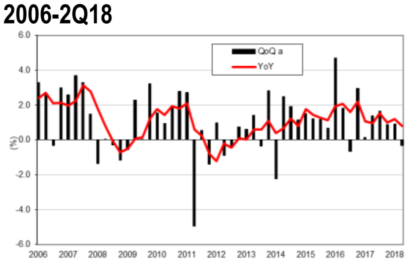
Source: INSEE, Santander.

Chart 24: GDP breakdown, 2015-2Q18



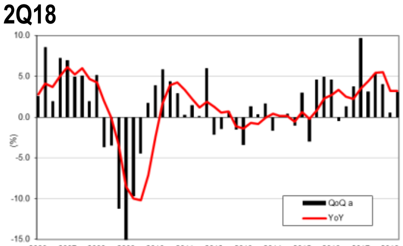
Source: INSEE, Santander

Chart 25: GDP - Private consumption, 2006-2Q18



Source: INSEE, Santander.

Chart 26: GDP- Investments, 2006-2Q18



Source: INSEE, Santander.

French GDP growth disappointed in 1H18. We expect better numbers in 2H18E

The French economy has notched up a very strong performance since 4Q16. GDP growth rates came in at an average of 0.68% QoQ in each of the quarters between 4Q16 and 4Q17, both inclusive. Annual growth rates moved above the 2.0% level in 2017 for the first time since 2011, taking GDP growth to 2.3% in 2017 from 1.1% in 2016. Actually, that 2.3% reached in 2017 was the strongest growth rate reported since 2007 (2.4%).

However, when everything pointed to more or less similar growth rates in 2018, GDP growth came in at a very modest rate in 1H18. GDP grew by 0.2% QoQ in 1Q18 and 2Q18, reducing the annual growth rate again to less than 2.0% (1.7% in 2Q18) and raising doubts about the strength of the fundamentals supporting 2017 growth rates. In our view, the French economy has the capacity to generate stronger growth rates than those of 1H18. We believe 1H18 was negatively affected by some special factors that will disappear in 2H18, pushing GDP growth up towards c.0.5% QoQ. 2019E GDP could actually beat that of 2018E.

1H18 GDP shows some one-off factors playing a key role …

GDP grew by 0.2% QoQ in each of the two first quarters of 2018. In our view, this poor performance was due in part to some “special” factors and global economic conditions. We do not expect it to be repeated in 2H18E, for which we expect stronger growth rates. The GDP breakdown showed the following:

- Private consumption rose by 0.2% QoQ in 1Q18 (0.2% QoQ in 4Q17) but fell by 0.1% QoQ in 2Q18. Consumption slipped in quarterly terms for the first time since 3Q16, reducing the annual growth rate to below 1.0% in 2Q18 from 1.2% in 1Q18 and 1.1% in 2017.

- Investments increased by just 0.1% QoQ in 1Q18 (1.0% QoQ in 4Q17) before accelerating to 0.8% QoQ in 2Q18. Business investments performed quite well (1.2% QoQ in 2Q18 from 0.1% QoQ in 1Q18) while households reduced theirs by 0.1% QoQ in 2Q18, after having grown since 3Q15. Public investments also picked up strongly (0.5% QoQ in 2Q18 from 0.1% QoQ in 1Q18).

- A negative contribution of net exports to the 2Q18 quarterly GDP growth of 0.2pp, reflecting a 0.7% QoQ increase in imports and an almost flat reading (0.1% QoQ) in exports.

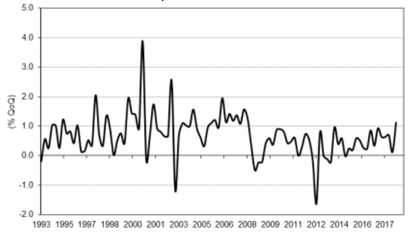
- In the end, both internal demand (domestic final sales rose by 0.2% QoQ in each quarter in 1H18) and net exports made a negative contribution of 0.1pp on average in 1H18.

Consumption set to recover in 2H18E, particularly in 4Q18E…and 2019E

In our view, consumption has been negatively affected by certain factors in 1H18, which we expect to change in 2H18E and, in particular, in 2019E, pushing private consumption growth rates higher.

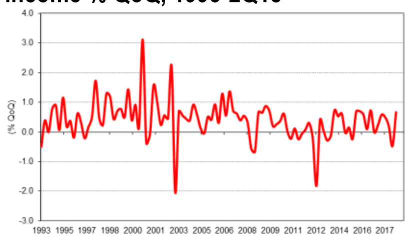
1) Transport strikes negatively impacted consumption in 2Q18. In real terms, transportation fell by 2.7% QoQ in 2Q18 (weakest

Chart 27: Nominal gross disposable income % QoQ, 1993-2Q18



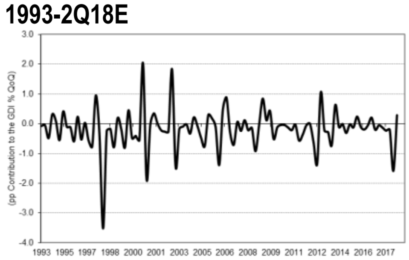
Source: INSEE, Santander.

Chart 28: Real gross disposable income % QoQ, 1993-2Q18



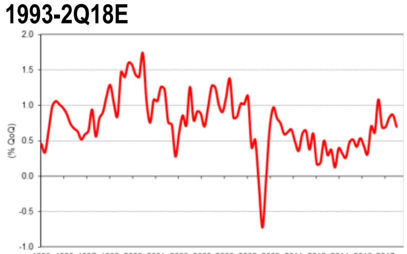
Source: INSEE, Santander.

Chart 29: Current taxes on income and wealth. Contribution to % QoQ GDI, 1993-2Q18E



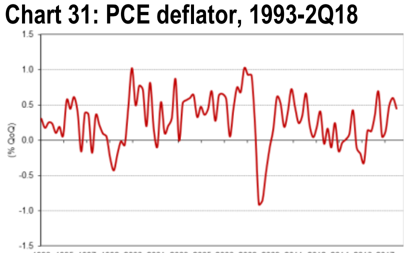
Source: INSEE, Santander.

Chart 30: Gross wages and salaries, 1993-2Q18E



Source: INSEE, Santander.

Chart 31: PCE deflator, 1993-2Q18



Source: INSEE, Santander.

performance since 4Q95), which implied a negative contribution of 0.1pp to the quarterly growth rate of PCE. We expect a turnaround in 3Q18E.

2) Weather conditions (warmer weather) in 2Q18 significantly reduced energy consumption (-3.6% QoQ and a -0.2pp contribution to the PCE quarterly growth rate). 3Q18E numbers could be better, with energy consumption picking up, also due to warmer than normal temperatures in summer.

3) Households' purchasing power (real gross disposable income) deteriorated sharply in 4Q17 (0.2% QoQ) and 1Q18 (-0.5% QoQ) after growing by 0.5% QoQ in 3Q17 and 0.6% QoQ in 2Q17. These poor real GDI numbers had a clear negative impact on private consumption. The culprits of the deterioration in real GDI were two: on the one hand, prices rose substantially in 4Q17 (0.5% QoQ) and 1Q18 (0.6% QoQ) mainly due to energy prices; while on the other, nominal GDI rose by 0.7% QoQ in 4Q17 but barely grew (0.1% QoQ) in 1Q18. The main culprit of the poor 1Q18 GDI numbers was taxes (current taxes on income and wealth rose by 9.6% QoQ in 1Q18, making a negative contribution of 1.6pp to the quarterly growth in GDI. On the other hand, gross salaries keep on growing at a very decent pace, supported by both employment and salaries per employee.

4) The impact of taxes (income and wealth) changed in 2Q18, falling by 1.6% QoQ (0.3pp positive contribution to quarterly GDI growth). The decrease of the negative impact of taxes in 2Q18 from 1Q18 was due to the substitution of the wealth tax (ISF) by the property tax. The contribution of social contributions to GDI was positive in both 1Q18 (0.8pp) and 2Q18 (0.1pp). Moreover, taxation will continue having a positive impact on GDI in 2H18E, particularly in 4Q18E, due to lower social contributions (elimination of the remaining unemployment insurance contributions for salaried employees) and the reduction in housing tax for certain households.

5) Inflation should stabilise and possibly decline at the headline level in 2019E. That would obviously have a very positive effect on real GDI measures, particularly after two consecutive years (2017-18) of very negative impact.

6) The 2019E public budget should include cuts to household taxes worth €6.0bn, which would clearly give an extra push to households' GDI and ultimately private consumption.

Strong investments vs. global uncertainty

We expect business investments to remain healthy over the rest of the year, with public investments also performing well (Greater Paris Express), while households' investments could decelerate a little in the short run. Production capacity constraints and tax credits for investments should support business investment during the remainder of the year. The new 2019 budget should also include tax cuts for companies worth €19.0bn.

Regarding the external sector, uncertainty is likely to persist in the coming quarters. In our view, export numbers should remain positive, although the trade war (high uncertainty about tariffs and protectionism), the appreciation of the euro (and its negative impact on competitiveness), geopolitical risks and the performance of oil prices would in our view be the main risks for trade and ultimately growth in the coming quarters.

Euro Rates Strategy: Looking for higher EUR rates, beyond the BTP volatility

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- **There are still headwinds to higher EUR rates but the policy trend and large lag vs. US rates point upwards for core yields.**
- **Italian spreads are likely to remain volatile, making outright BTPs a poor risk-reward proposition. On the other hand, we look for a steeper spread term structure as near-term credit risk looks overstated.**
- **In that overall context, SPGBs offer a strong mix of yield pick-up and moderate fundamental risk and we remain overweight.**

Shallow rising rates trend still intact, despite understandable investor scepticism

The rise of EUR core rates during September should restore **some faith in the shallow bearish trend** that began from the all-time lows in two years earlier. It is necessary to qualify that statement with the word 'some', given that: a) between mid-February and late August of this year the 10y Euribor rate printed a series of lower highs and b) the recent rise in rates has yet to reach the February or even the May relative highs (Chart 32).

Chart 32: Euribor 10y rate

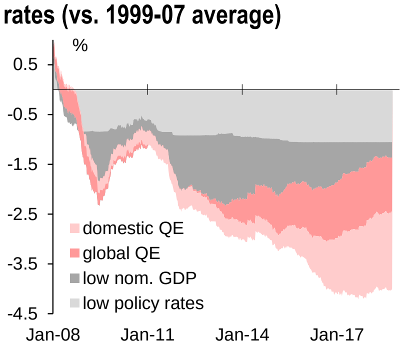
Source: Bloomberg, Santander

All the same, we find that scepticism about significantly higher rates is, understandably, still prevalent. For instance, how do we justify the increase of roughly 95bp implied by our end-2019 forecasts for 10y Euribor rates? Consider that since Q4-16, the annual pace of increase in 10y Euribor has been closer to 35-40bp.

On the macroeconomic front, the **PMIs and Economic Confidence indexes suggest further Eurozone GDP deceleration in Q3**, following on from the y/y rate slowing from 2.8% at the peak last year to 2.1% in Q2. Meanwhile, core inflation in the Euro area remains firmly around 1% (0.9% in the latest flash estimate), despite the ECB (and private-sector) forecasts always 'promising' that 1½%-1¾% levels are just around the *next* corner.

Additionally, volatile market action in economies like Turkey, Argentina and even Italy serves as a reminder **that a host of financial fragilities worldwide could limit the ability of G7 central banks to deliver tighter policy** in the medium term.

Chart 33: Determinants of 'low' 10y rates (vs. 1999-07 average)



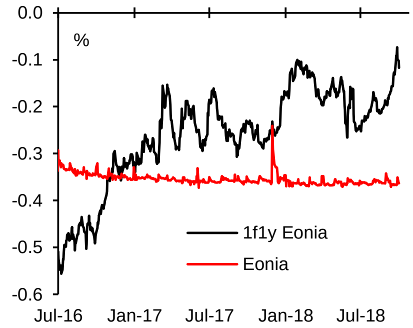
Source: ECB, Eurostat, Santander

Against all those reasons to doubt higher rates, however, we must also consider the extremely low starting levels and the extent to which they reflect a monetary policy stance that is on its way out. Both at the global and EU-specific level, **quantitative easing is being phased out**. Although the pace of central bank balance-sheet reduction, in aggregate, is set to be very slow, the lack of net drawdown of core EGBs is bound to have an upward effect on core rates. Econometric evidence strongly suggests that external and ECB-based QE programmes account for a substantial portion[1] of the 360bp deviation between current 10y Euribor rate levels and the 1999-2007 average level (Chart 33).

Equally, we would argue that the market has interpreted the ECB's enhanced forward guidance asymmetrically; as insurance against early rate hikes. However, the starting date will ultimately matter less than the pace and scope of policy normalisation in 2019 and successive years. Greater

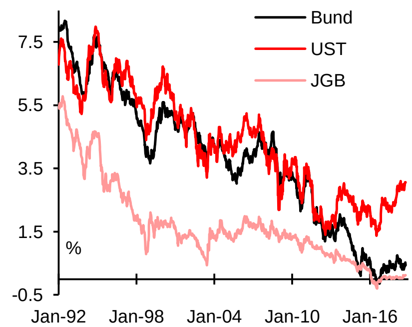
[1] The model shown in Chart 33 estimates the extent of the QE-determined deviation to be over 260bp. Even if that is substantially overstated, the end/roll-back of QE programmes will be a significant event.

Chart 34: Spot and 1f1y EONIA



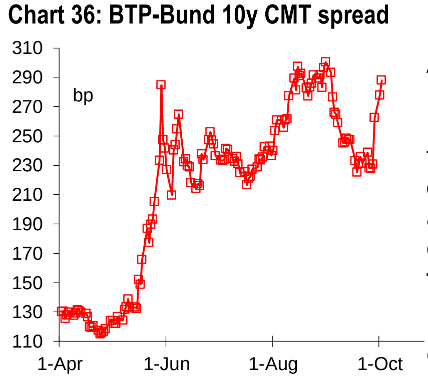
Source: Bloomberg, Santander

Chart 35: 10y Bund trades near JGBs, not USTs



Source: Bloomberg, Santander

Chart 36: BTP-Bund 10y CMT spread



Source: Bloomberg, Santander

realism might be seeping into pricing, with the 1f1y EONIA swap recently breaking to the upside (Char 34).

Another strand of evidence of the policy-dominated and ultimately unsustainable degree to which EUR rates are distorted downward is the contrast we have repeatedly mentioned between market-based inflation expectations, like inflation-linked swaps (ILS), and 'real' rates. ILS levels are somewhat below recent highs (around 1.6% in 10y) and continue to reflect disappointing levels in underlying core inflation as well as a lack of substantial term premium. However, ILS levels do reflect the (gradual) reflation process in the economy. **Conversely 'real' Euribor rates remain at ultra-low levels (around -0.6%); we would argue that this is largely policy-determined**.

Another piece of evidence as to the richness of EUR rates is how closely they trade to JGB yields as opposed to UST yields (Chart 33), despite the fact that Euro area nominal GDP growth has been considerably closer to US than Japanese levels. **Overall, we stick to the view that investors and borrowers should be positioned for higher real (and nominal) rates in EUR.** In position terms, we would recommend the following:

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

ASW UST 2.875% May-2028 & XCS into € vs. RASW Bund 0 5% Feb-2028. This trade is close to the initial entry level at a pick-up of 30bp.

Trade idea: EUR 5s30s 'bearish' flattener

Pay 5y IRS fixed and receive 30y IRS fixed. The current spread has tightened to 116bp. We target a test, then break, of the 106bp low. The 3-month carry cost on such a flattener is roughly 1bp.

Trade idea: Higher 10y real rate

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

Taking a balanced view on BTPs

Given the degree to which Italian developments have dominated periphery EGB markets over the past months, it makes sense to start there. As we wrote recently, **we view** outright **BTP-core spread positions as unattractive, low-conviction, high-risk trades in the foreseeable future**. This has been reflected by **very volatile trading** behaviour. The root causes of the unpredictability are the mix of challenging long-term economic/fiscal conditions, the unconventional political environment and, on the other side, a broader context of still very moderate interest rates that naturally creates demand for high-yielding sovereign paper.

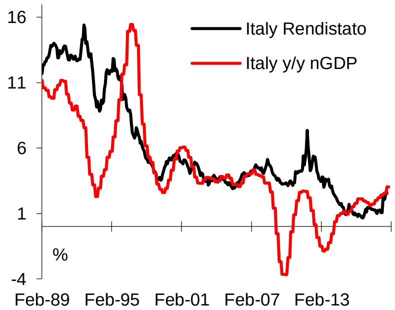
As suggested last month, **market focus** where BTPs are concerned has been **almost entirely on the 2019 budget** process. Earlier in September, BTP spreads tightened sharply as news flow suggested that the technocrats in the government would present a deficit target around 1½% of GDP. However, the 'populist' element took the upper hand and put forth a figure around 2.4% for 2019 and following fiscal years[2]. Given Italy's low growth, such a target makes it **difficult to reduce debt, or perhaps even to stabilise it.** This **followed a period of fast-money reallocation into BTPs and the reaction has been sharply negative** (Chart 36).

On top of that, October could be an important month for Italy on the ratings front. There is a scheduled review by S&P (BBB, stable) and Moody's has postponed their September-scheduled review to October (Baa2, negative). A significant deficit increase, relative to EC/IMF/previous government

[2] There has been some backtracking on this, with targets of 2.2% in 2020 and 2% in 2021 being mentioned.

projections certainly **leaves the door open to rating downgrades or negative outlooks**. Last but not least, domestic investors are already very long Italian sovereign debt.

Chart 37: Italian borrowing rates are still not that high vs. nominal GDP

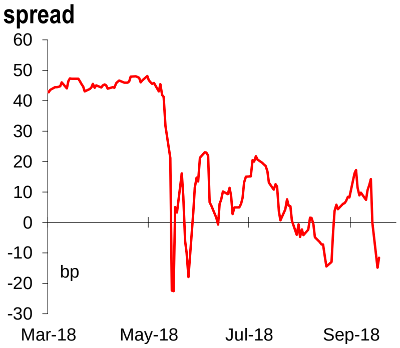


Source: Eurostat, Bank of Italy, Santander

Fiscal slippage is bad news, undoubtedly, but it should be contextualised. Even after the spike in spreads**, Italian debt cost** in absolute terms and relative to nominal growth is nowhere like the 1989-1993 or 2010-2014 critical levels Chart 37). As such, it looks **sustainable in the medium term**. Also, notwithstanding the deceleration in EMU and Italian real growth levels, the current account and direct investment balances remain positive. Unit labour costs have continued to move towards more competitive levels. The **implied cumulative probability of default/redenomination for 10y BTPs looks high** around 35-40%; the figure for 5y is around 20.

In terms of overall exposure, we remain of the opinion that EGB-benchmarked investors should be underweight or at least neutral BTPs. Rather than the outright spread trade, we perceive an opportunity in the behaviour of the term structure of spreads. Notwithstanding the poorer financing conditions faced by the Italian Treasury and the often Euro- and EMU-sceptic tone taken by League and 5-Star politicians, we see little evidence of an actual intention to drop the euro.

Chart 38: BTP-Bund 2037-2025 box spread



Source: Bloomberg, Santander

The fiscal risk for Italy is greater in the long term, given low growth and the emergence of anti-enterprise policies, which arguably could further reduce that growth. **The marginal (annual) default probability term structure in Italy should not be flat or inverted – it should be positively sloped**. **From the 5y point onward, the BTP-Bund spread is essentially in a flat range** (close to 265-300bp as we write). Even at shorter maturities, the premium is relatively attractive, such as 3y paper paying around 250bp over Germany. We recommended a BTP-Bund 5y – 15y box spread 'steepening' in late August, which performed by over 15bp in the space of a week. We think a similar trade makes sense currently:

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

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

The current box spread is -12bp. We target just above the recent range, at +20bp, and would add to the position if better (more negative) levels are achieved. The carry is positive (roughly 1bp per month).

SPGBs retain a strong risk-return profile

Spain's output and employment growth figures continue to handily outpace the rest of EMU, looking more like US ones. For instance, Q2 real GDP growth came in at 2.7% y/y, compared to 2.1% for the Euro area and 2.9% in the US. Fiscal figures in the year to July show improvement vs. 2017 and **Spain is on course to push its debt/GDP ratio a little further below the 100% level**. This robust performance underpins the **investor consensus to remain positively exposed to SPGBs**. Nonetheless, SPGB risk premia remain somewhat exposed to BTP trading conditions. As Italian spreads widened to new all-time highs vs. Spain earlier in Q2-Q3, that price action capped potential SPGB gains somewhat. Notwithstanding the difference in fundamentals, periphery optimists had a far higher set of sovereign risk premia available. Another factor potentially exercising pressure on SPGBs might have been EM contagion effects. These have been less prominent of late but Spain remains somewhat more exposed than other EMU countries to this sort of risk.

Perhaps as a reaction to the Italian budget concerns, **the 2019 Spanish budget process is a focus** for fixed income investors, too. The 2018 figures, to date, suggest a material improvement relative to previous years. There is less clarity regarding 2019. The PSOE government would like to target a deficit of 1.8% of GDP (compared to the 1.3% projection by the preceding PP government). There is ongoing discussion between PSOE and Podemos about revenue and expenditure measures but the real stumbling block is that the 2019 budget, under the stability law, needs to be passed by both houses of parliament. With the PP (and Ciudadanos) unlikely to accede to PSOE demands and the PP holding a blocking majority in the Senate, **the chances of a PSOE-Podemos budget being passed in the near term are seen as slim**.

It could be argued that the PSOE's platform of moderate fiscal expansion and re-distribution serve their purposes even if the budget is *not* approved insofar as they help campaign ahead of a possible return to the polls. Although they have not linked the budget and early elections directly, the PSOE has admitted that the latter are a possibility. Poll results are volatile and not always reliable but since heading the executive, the PSOE has pulled ahead in the polls, though recent figures do not suggest an outright majority result.

The whole process naturally attracts investor attention but the key fiscal fact to bear in mind, from a credit perspective, is that **whether the PSOE get their way (slightly higher taxes and spending) or not (extension of the 2018 budget provisions into 2019), the prospect is for a general government balance that is, again, well below expected nominal GDP growth**, even taking into account a gradual deceleration in real GDP growth. Employment growth remains solid in Spain, with positive fiscal consequences in the form of higher tax revenues and lower welfare outlays.

Lastly, note that on 5 October (Friday), Spain's sovereign rating faces the last scheduled review of the year (by Moody's). Like the other three ECB-recognised agencies, Moody's gave Spain's rating an upgrade earlier in the year. No change is expected this time around but at some point the rating outlook should go from 'stable' to 'positive'.

Although not as wide as BTPs, **SPGBs still pay 110bp over 10y Bunds, which is roughly 50bp above Q1 lows**. We think that **EGB-benchmarked investors should be positioned substantially overweight SPGBs**. One way to quantify the risk-reward attractiveness of Spanish paper is to point out that the implied cumulative default probability for 10y SPGBs is just shy of 25%, which is quite a bit closer to Italy than Germany. That, like the current sovereign ratings of Spain, does not accurately reflect current and prospective debt/GDP levels relative to other EMU issuers.

<u>Trade idea:</u> SPGB outperformance

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

The current spread is 112bp. We target 70bp. The carry is positive (around 1bp per month).

Euro government bond supply: YTD update

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Slight change in the EZ's combined issuance target

On 20 September, the German Federal government again modified its total gross financing needs (i.e. money market and capital market instruments) for this year from €175bn to €173bn, updated in the third quarter and excluding inflation-linked securities. The original amount announced in December was €183bn and has undergone modifications in the second and third quarters. In capital market instruments, the latest reduction will be €1bn and will take the target for gross issuance from €29bn to €28bn in the fourth quarter (excluding linkers). Thus, Germany will end up issuing €145bn (vs. €147bn before) over the entire year, taking into account €7bn in linkers.

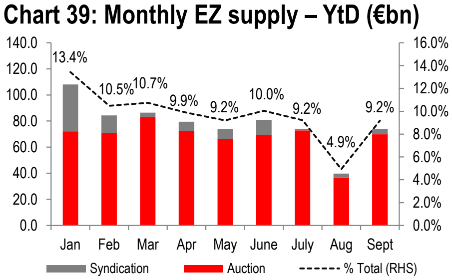
Also, in its Quarterly Outlook released on 21 September, the DSTA updated its total borrowing requirements for 2018, lowering the figure from €52.1bn to €47.9bn thanks to an improvement in the Dutch cash surplus position this year, resulting from "the fast growing economy, which has led to corporate tax income in particular being higher than forecasted". In terms of long-term borrowing requirements, the DSTA said that "due to the lower funding needs", it will now be targeting the lower end of the communicated issuing range of €23-29bn (we had estimated the upper bound, €29bn), so the total issuance amount for the Netherlands points towards €23bn for 2018.

Considering the slight change in both Germany (from €147bn to €145bn) and the Netherlands (down from €29bn to €23bn), we now estimate a combined Eurozone 2018 borrowing requirement equivalent to €805bn (€813bn previously). As we enter the last quarter of the year, some EUR issuers have almost reached their targets for medium-to-long term debt this year. With three full months to go to the end of 2018, we expect them to continue issuing debt to take advantage of both current market conditions and the last stretch of the ECB's EAPP, which ends in December.

Towards 90% completion of Eurozone govie issuance

We are seeing a recovery in the region's sovereign debt issuance in September, as shown in Chart 39, after the summer break. Through the last week of September, EUR issuers have sold more than €700bn of bonds via both ordinary auctions (€614bn) and syndicated deals (€87bn), representing an average of 87.1% of the newly revised 2018 issuance target mentioned above (€805bn).

Chart 39: Monthly EZ supply – YtD (€bn)



Source: Bloomberg, Santander

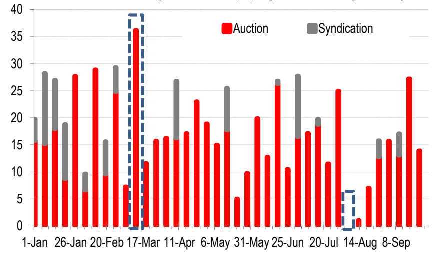
Table 3: Total issued in EZ in 2018, by country (updated as at 28 September)

	GE	FR	NE	AS	SP	BE	PO	IT	IR	FI	TOTAL EZ (€bn)
YtD auctioned issuance	116.0	173.4	19.8	9.9	83.7	20.9	6.7	175.5	5.7	2.0	613.6
YtD syndicated issuance	0.0	7.5	0.0	4.8	27.0	9.5	8.0	16.7	8.0	6.0	87.5
YtD Issuance	116.0	180.9	19.8	14.6	110.7	30.4	14.7	192.2	13.7	8.0	701.0
2018 programme	145.0	195.0	23.0	18.5	131.3	31.0	15.0	219.0	16.0	11.0	804.9
% completion (RHS)	80%	93%	86%	79%	84%	98%	98%	88%	85%	73%	87%

Source: Bloomberg , Santander

In terms of YTD completion rates by country, Belgium and Portugal (both at 98%) are close to reaching their 2018 issuance objectives (taking into account all the syndicated deals). The next in line for the 100% mark is France, which has already covered 93% of its 2018 target, followed by Italy and the Netherlands at 88% and 86%, respectively. The remaining EUR issuers, except for Ireland (85%), Spain (84%), and Germany (80%) are below the 80% mark. Austria

Chart 40: Weekly EZ supply – YtD (€ bn)



Source: Bloomberg, Santander

Table 4: YTD issuance completion vs. historical data

	2013	2014	2015	2016	2017	2018	Aver 13-17
GE	76%	76%	81%	84%	79%	**80%**	79%
FR	80%	80%	81%	83%	81%	**93%**	81%
NE	88%	88%	83%	84%	71%	**86%**	83%
AS	85%	86%	79%	68%	95%	**79%**	83%
SP	79%	80%	84%	81%	79%	**84%**	81%
BE	92%	86%	83%	88%	91%	**98%**	88%
PO	100%	87%	87%	90%	82%	**98%**	89%
IT	74%	81%	82%	77%	80%	**88%**	79%
IR	100%	60%	93%	79%	68%	**85%**	80%
FI	89%	89%	96%	85%	85%	**73%**	89%
TOTAL EZ (€)	**79%**	**80%**	**82%**	**81%**	**81%**	**87%**	**81%**

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

(79%) is making gradual progress towards its completion target, along with Finland (73%), which is lagging behind at the end of September (see Table 3).

In terms of weekly averages, Chart 40 shows sovereign EUR issuance in the first 39 weeks of the year. We can clearly see that, in the last four weeks, activity has only picked up in auctions, with few syndicated deals (which is usual at this point of the year), taking the Eurozone's weekly average to around €18bn (from €19.5bn before August) at the end of September. 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 40.

As depicted in Table 4, 2018 is proving another record year, with a number of EUR issuers taking their average completion rates to fresh highs for this stage of the year. Belgium (98%), France (93%), Italy (88%), and Spain (84%) have set new records in terms of bond issuance completion rates in at least the last five years. For the Eurozone as a whole (87%), this average completion rate is also well above the levels seen at this stage of the previous five years (81% for the 2013-2017 period) thanks to front-loading due to the improved macroeconomic environment, with the continued help of the ECB's extraordinary monetary policy measures.

France and the Netherlands: first estimate of funding needs for 2019

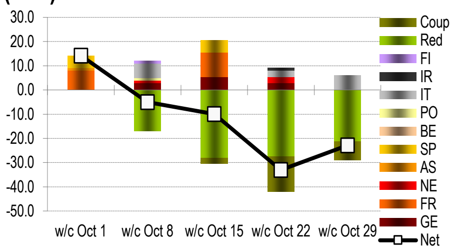
According to the DSTA's Quarterly Outlook, the Netherlands is expected to need around €1bn less funding next year than in 2018 given lower capital market redemptions and "another significant cash surplus" forecast next year. According to our estimates, DSL requirements for 2019 could be similar to this year's, i.e. around €22-25bn, as the Dutch agency uses the cash surplus to cover part of next year's redemptions (€29.8bn). We will have to wait until 14 December, when the DSTA publishes its Outlook for 2019, for more details on the borrowing requirements for next year, as well as the 2019 funding plan.

Also, on 24 September, the AFT announced its funding requirements for 2019, after the French government adopted its 2019 budget. Next year's financing needs are estimated at €227.6bn, with the medium- and long-term securities (namely OATs) issuance amounting to €195bn, the same as that targeted for the current year. According to the AFT, of the total, €98.7bn will be used to finance the deficit, and €130.2bn for the redemption of its medium- and long-term debt maturing in 2019. Note that the details of next year's French funding programme will be published in December.

Supply dynamics: Negative net EUR supply this month

In October, we expect more than €60bn in new auctions (excluding syndicated deals). We expect France and Italy to issue €18bn and €15bn, respectively, Spain in the range of €9-10bn and Belgium is scheduled to skip issuance in October, as announced in its 2018 issuance programme. Germany has already announced that it will issue €11.5bn (excluding linkers). Also, the Netherlands will be reopening two DSL lines in October for up to €3.5bn (on 9 and 23 October). Portugal, Ireland and Finland could also issue debt this month. However, scheduled redemptions of more than €93bn and coupon payments of €25bn (including Spain's €21.2bn in bond

Chart 41: Expected net EUR bond supply (€bn)



Source: Bloomberg, Santander

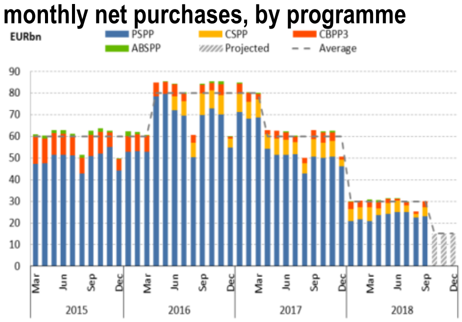
redemptions and €7.7bn in coupon payments on 31 October) will be enough to offset October's supply and support the European bond market. Consequently, net EUR issuance will be negative by around €57bn for the next four to five weeks (Chart 41).

Update on the ECB's EAPP

The latest report published by the ECB on its Extended Asset Purchase Programme (EAPP) holdings, covering the purchases settled as at 28 September, shows that the ECB has accumulated more than €2.53trn in assets since the programme began in March 2015. According to the latest report, the PSPP portfolio totals €2.08trn in Euro govies and supras, accounting for 82% of the ECB's monetary policy portfolio, while CPBB3 holdings now amount to €259.3bn, which represents 10.2% of the portfolio. The CSPP has reached €170.4bn, and the ABSPP now stands at €26.9bn, representing 6.7% and 1.1% of the total, respectively.

Country-wise, the most recent information available is a breakdown of the PSPP debt security holdings published by the ECB on 2 October. The latest figures show that the EAPP grew by €29.7bn in September (c.€5bn more than in August, or +19.7%), of which €23.2bn corresponded to the PSPP (above last month's €22.6bn or €592mn more). Of these €23.2bn, €21.5bn were euro-denominated public debt securities including agencies (+€1.1bn vs. August), and the remaining €1.7bn (again, 10% of the PSPP) are supranational debt, €522mn less than the previous month. More specifically, as illustrated in Table 5, the September country breakdown shows activity generally picking up, with Finland being the most notable exception (from €489mn in August to -€355mn in September), followed by Ireland (-€170mn change) and Luxembourg (€24mn decrease vs. August). The Netherlands shows an increase of more than €600mn, entailing the second largest surge in purchases in the month of September after Germany's €896mn positive change. In the case of Spain, France, and Italy, their asset purchases increased by €239mn, €98mn and €32mn compared to August, respectively, representing 74% (when Germany is added) of all the PSPP buying. See more details here.

Chart 42: The ECB's EAPP portfolio: monthly net purchases, by programme



Source: ECB

Table 5: The ECB's PSPP purchases - Country breakdown

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

Source: ECB, Santander

UK Economic and Rates Outlook: Are we nearly there yet? (No)

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- **The Brexit process has ground on slowly and noisily**
- **The Irish backstop remains a very difficult sticking point**
- **The market has increasingly looked through dramatic headlines…**
- **So UK rates have largely followed September's sell-off in USTs**
- **We still expect a Withdrawal Agreement to be concluded by November**
- **But that will not end the uncertainty: the 'deal' will necessarily be vague on the future relationship, faces a rough ride through parliament and even possibly another referendum or election**
- **Nonetheless, rates look set to continue tracking those in the US, as the market has become accustomed to this confused backdrop**
- **Front-end inflation pricing has surged despite a stabilisation of the currency, and looks unsustainably high given the very limited pricing for a 'no-deal' Brexit seen elsewhere**

Brexit remains the only story that matters in the UK news

For yet another edition of Interest & Exchange, the market's eyes remain firmly fixed on the road to Brexit. Unfortunately, the story did not go as the UK government was hoping in September: rather than the EU leaders' summit in Salzburg proving a breakthrough, it ended with a surprisingly blunt rebuff of Prime Minister May's "Chequers plan". The PM followed up with her own defiant press conference the next day, adding to the confrontational atmosphere and seeming to put compromise further out of reach.

We hope that there was at least some element of theatricality to these events, with the leaders each having an eye on their own domestic audiences – particularly Theresa May, facing steady, seemingly implacable sniping on her negotiating stance from the anti-EU wing of her own Conservative party and a challenging party conference due to begin ten days later. As has often been the case with EU "crises", a heightened sense of jeopardy and impossibility may just be an inevitable precondition for a breakthrough.

Avoiding a cliff edge is (still) all about Ireland

We have long argued that the Irish border is an extremely difficult problem to solve but that an orderly Withdrawal Agreement cannot be completed without it. Anyone who considered last December's Joint Declaration and the progress towards a legal text announced in March as a 'done deal' was premature, given this outstanding puzzle.

Technical steps towards "de-dramatisation" of the critical Irish backstop problem seem to be continuing backstage, and we remain optimistic that an adequate compromise can be found by November: the consequences if the Withdrawal Agreement, and in turn the Transition Period, fails would be particularly acute for both the Republic and Northern Ireland.

There would also, of course, be significant impacts for UK consumers and businesses in the event of crashing out with no UK-EU legal framework in place on 30 March. We examined some of the potential direct economic consequences of a 'no-deal' scenario in a major note on 17 September: key points include as much as a 1%-pt shock to CPI and particularly large effects on the motor vehicle, food-producing and clothing & footwear industries.

Monday (1 October) saw media reports that the UK government was preparing a “significant new offer” regarding the border and, even before any official announcement of what that offer might be, the DUP responded with a loud reiteration across the media of their own red lines on the GB-NI border.

We recall that the DUP’s 10 Westminster MPs have a “confidence and supply” agreement to keep the Conservatives in power, so their consent to any deal has importance even beyond their representation of a community at the centre of the NI controversy. All of the other 7 Northern Irish MPs belong to Sinn Féin, who do not take their seats at Westminster on principle.

Even if that were not the case, the PM would be unable to bypass the DUP and appeal directly to the rest of the Northern Irish Assembly (Stormont) for consent, as political deadlock between the DUP and Sinn Féin means the Assembly and administration have been suspended since January 2017.

There is one other topic on which agreement is still required, but we expect that Protected Geographic Indications, such as the definition of champagne, could be resolved fairly swiftly were the Irish backstop to be nailed down.

Expect more speculation than declaration on the end state

Unfortunately, we do not believe that the dense fog of Brexit uncertainty will lift even if and when the Withdrawal Agreement is concluded. The legally-binding exit arrangements were always due to be accompanied by a (non-binding) mutually-agreed statement on what the future UK-EU relationship should look like, post-2020, but expectations for the detail and clarity of that side document have faded the longer that negotiations regarding the essentials have dragged on.

Theresa May’s official “Chequers plan” has been widely criticised both within her own party and across the EU, leading to a general sense that it will need considerable modification, at least, to reach a final agreement. It may well take a new leader with a fresh mandate to be able to push any final deal through both parliaments and the EU leaders – although whether that mandate comes from the Conservative party, a general election or a fresh referendum is another hotly-debated question.

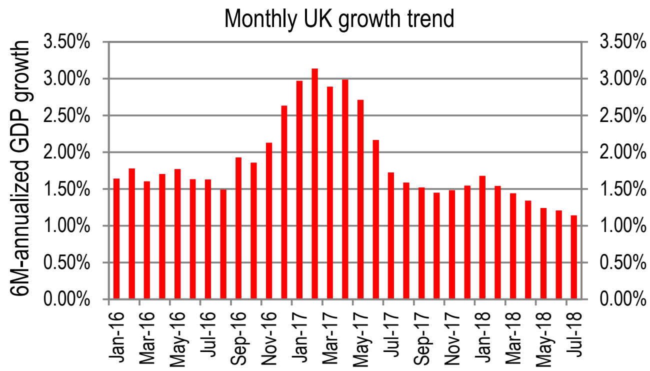
To sum up, our central scenario is that a **basic Withdrawal Agreement** is reached, most likely at the mooted special summit on 17-18 November, implementing the 21-month transition period and leaving the regulatory environment effectively little changed until 2021. But we also expect that :

- **the eventual form of the Brexit outcome will remain unclear**
- **dramatic deadlines will continue to come and go on a regular basis**
- **various types of inherently unpredictable democratic decisions remain in play (including the European parliamentary elections next May)**
- **economic dynamism in the UK will remain subdued, as seen so far in 2018, rather than a return to those of 2016 or better (Chart 43)**
- **businesses and markets remain unable to make forecasts and plans for the medium-term future**

Low conviction between wildly different possible outcomes leaves UK markets simply following the US

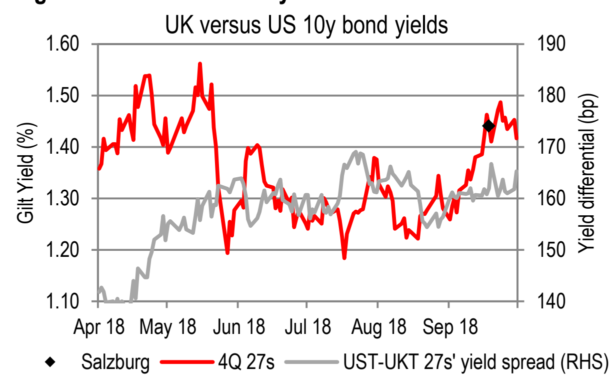
Despite all the drama and opacity described above, the UK rates market has shown none of the idiosyncratic behaviour of, say, Italian spreads. For instance, after the markedly uncivil conclusion to the Salzburg summit, gilts barely flinched: although there was some minor day-to-day volatility, 10y UKT-UST spreads remain very close to the levels they have held ever since the start of the summer (Chart 44).

Chart 43: UK GDP growth still appears to be on a downward trend (and looks even weaker in 2Q18 if retail is excluded)



Source: ONS, Santander. Note: The ex-retail industry measure of GDP accounts for 89.6% of UK GDP on an output (GVA) basis.

Chart 44: We see September's sell-off in gilts as driven by that of USTs, as the 10y spread between them has stayed tightly range-bound since mid-May



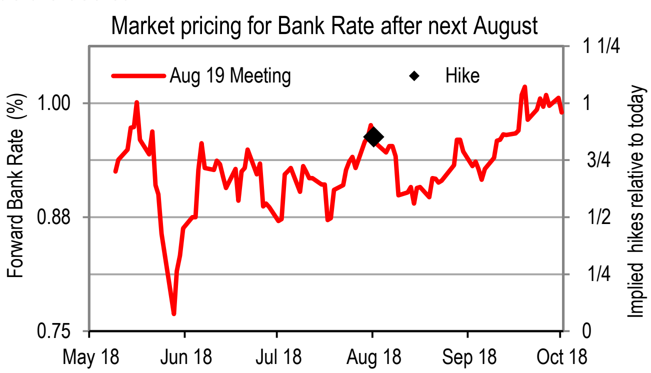
Source: Bloomberg, Santander.

Indeed, we see the gilt's whole ~17bp sell-off over the course of September as pretty much entirely attributable to the 19bp sell-off in comparable US Treasuries: all the sound and fury coming out of the Brexit process was taken as signifying nothing. We largely agree with the logic of that interpretation!

Our GPB term rate forecasts for the year ahead have moved rather higher since the previous edition of this report, even though the grinding progress on Brexit is pretty much what we expected. What has changed is that we no longer see the UK-US differential as able to widen much further without a full-blown crisis actually beginning to happen. Given the robust bear market in US rates, and our long-standing forecast that yields there will end the year around 3.25%, this implies that gilts should also continue to tend cheaper.

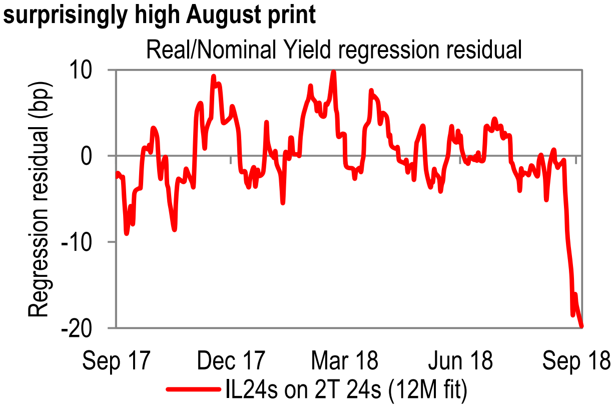
The upside surprise in the UK's latest inflation readings also failed to distort the bp-for-bp link between UK and US term rates (August CPI 2.7% YoY, compared to a 2.4% consensus and 2.5% previous rate), reinforcing our confidence that US rates will remain the dominant influence on the UK's. It did have an impact on the short-run profile of Bank Rate, bringing the next market-implied hike forwards to August (just) from late-2019 (Chart 45). If the central Brexit scenario described above plays out, that seems like a reasonable anchor for the market with room to flex on either side as the data comes in. But we remain dubious that the economy will ultimately look robust enough for the MPC to hike again that soon, even under that relatively smooth Brexit path.

Chart 45: The market is now as confident in another Bank Rate hike by next August as it has ever been – but is still pricing it as a close call



Source: Bloomberg, ICAP, Santander.

Chart 46: Front-end UK inflation pricing has surged since the surprisingly high August print



Source: Bloomberg, Santander.

The bearish influence from the US should remain weaker at the front end, as the monetary policy stances are evidently different (however much the MPC would like to join the Fed's hiking cycle), so we still forecast further divergence in 2y and 5y GBP-USD rates.

This naturally implies a steepening view on the front of the UK curve, which we believe is also consistent from a domestic perspective: the market could increasingly try to differentiate between short-run Brexit disruption to confidence, politics, the economic environment and monetary policy versus a (very long awaited) return to 'normality' over the medium term (5y+).

Trade idea: GBP 2s10s steepener

Enter at 47bp, target 60bp, stop at 44bp.

Close trade idea: GBP 5s10s steepener from 15 Dec 2017.Although slightly in the money once roll-down is accounted for, and still generally attractive for the same reasons as the 2s10s idea, we find the wider expression more compelling as it is more directly exposed to the sticky UK monetary policy that we anticipate.

That spot inflation surprise also combined with crude oil prices' march on to 4y+ highs to give front-end gilt inflation breakevens and RPI swaps a major boost. We believe those levels are unsustainable unless a 'no-deal' Brexit is being seriously priced in, which would contradict the recent strengthening of sterling and resurgence of BoE hike expectations. This has taken the IL24s' BE to 318bp, its outright widest since April 2017 and almost 20bp rich on regression versus nominal yields (2T 24s, Chart 46). We recommended selling this breakeven (on an 85%-beta-weighted basis) on 21 September; although that proved very premature, we advocate that trade (or the RPI swap equivalent) even more strongly at current extremes.

G10 FX Outlook

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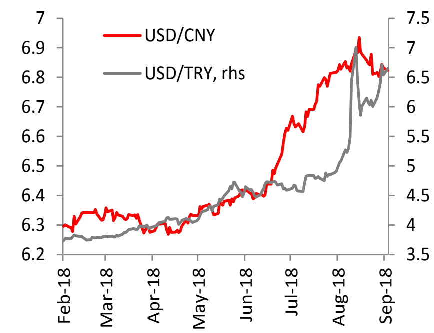
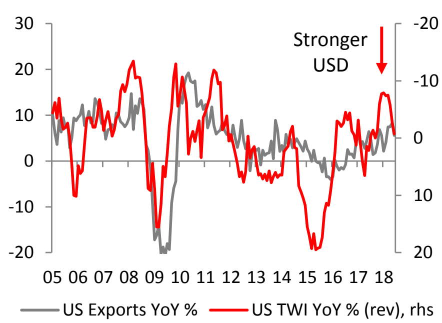
Taken from our latest FX Compass, published 20 September

Chart 47: Risk factors and US protectionism have provided support for the USD…



Source: Bloomberg, Santander

Chart 48: …but we need to reiterate that protectionism does not sit well with a strong USD



Source: Bloomberg, Santander.

USD – Priced in?

The USD remains strong. A mixture of solid economic data, higher interest rates and low risk appetite has continued to support the dollar. However, the USD index has not been able to retest its August high, which might suggest that this USD-positive good news is viewed as already priced in. Hence, we still suspect that the currency may be vulnerable to market repositioning over the coming months and into 2019.

The market's focus remains on trade tensions between the US and China. The US trade deficit widened to $72.2bn in July, a 12% YoY increase, while president Trump announced in September that a tariff of 10% would be imposed on a further $200bn of Chinese imports. Plus, the tariff may rise to 25% if a trade deal is not reached between the two by the end of 2018.

China indicated that they would retaliate, sending risk appetite lower, amid concern about the impact trade conflict will have on equities and global growth. The FX market had appeared to be 'getting used to' protectionist rhetoric, and not always viewing it as USD-positive, although the extra tariffs did support the USD, as did later comments that suggested that the trade talks with Canada were not advancing.

However, the combination of a wide trade deficit and worries about the US budget deficit and debt may imply that the dollar is more vulnerable than the market is presently willing to admit. Further, we reiterate that a protectionist US should be unwilling to allow the USD to strengthen and eat away at competitiveness. Indeed, further gains might be capped by speculation that the president may highlight his unhappiness about the dollar's strength.

Aside from these concerns, the fundamental backdrop is likely to remain dollar-friendly over the coming months. After hiking rates in September, the Fed increased its 2018 GDP forecast to 3.1% from 2.8%. Overall, economic data remain firm, with headline CPI at 2.7% YoY in August, unemployment at 3.9%, and ISM and other confidence indicators highlighting good sentiment.

The main risk to the USD from the data is that the currency's recent strength has priced in all the good news. Indeed, the US economic surprise indices are broadly flat, suggesting that the market is not being fed the better-than-expected data that might be required to encourage further USD buying.

A similar point can be made about US interest rates. The headline level and differential with its peers continue to offer support for USD/G10 pairs. Given that the Fed hiked rates in September and is expected to hike later this month, again in December and then more in 2019, interest rates should prevent any significant weakness in the currency.

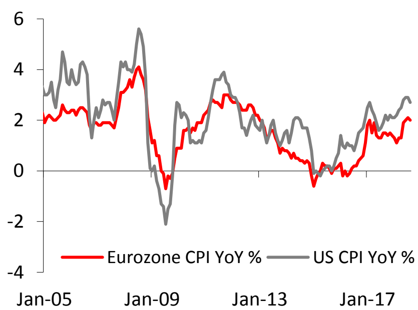
However, with those hikes expected and with the ECB starting to sound more confident about Europe's outlook, the focus over the coming months may shift towards the scope for tighter monetary policy in other countries. In addition, slower global growth due to trade tensions may undermine expectations of more US rate hikes, as might the prospect of an inversion of the US yield curve and fears of signals indicating slower US growth looking ahead.

EUR – A less pessimistic ECB

We remain upbeat about the EUR over the coming months and into 2019. The currency is still under pressure against the USD, as low risk appetite continues to favour USD strength, but a robust economic outlook for the Eurozone and a more confident-sounding ECB should provide support.

The ECB kept its monetary policy unchanged following the September meeting. However, despite a small downward revision to its GDP forecasts (growth is now expected to be 2% this year and 1.8% in 2019), the Bank's general tone was more upbeat.

Chart 49: A firm growth outlook and solid inflation seem to be boosting ECB confidence



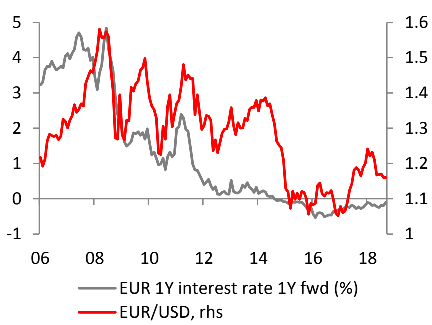
Source: Bloomberg, Santander

The Bank believes that recent data confirm that the economy can look forward to 'ongoing broad-based growth'. In addition, it still believes that the risks surrounding the GDP outlook are 'broadly balanced'. The optimistic stance from Draghi et al took the market somewhat by surprise, given that it had become used to the ECB tending to talk up risks, which would in turn weigh on the EUR.

Further, the Bank's upbeat rhetoric extended to the inflation outlook. The final August CPI data confirmed headline inflation at 2% YoY, with the core rate at 1% YoY. In addition, the ECB kept its forecast for headline inflation unchanged, continuing to estimate CPI at 1.7% in each year through to 2020. Admittedly, the core CPI forecast was cut to 1.5% YoY in 2019 and 1.8% in 2020, but any negative impact on the EUR from this revision was blunted by Draghi's expectation that inflation will increase.

The ECB's president highlighted the ongoing acceleration of wages as a reason behind the Bank's confidence that inflation will remain elevated. Moreover, he added that significantly stronger core inflation can be expected.

Chart 50: Expectations for a sooner than expected ECB rate hike may have to emerge to allow the EUR to hold on to any future gains



Source: Bloomberg, Santander

The Bank also repeated that its asset purchase programme will finish by the end of the year, something that we think should be viewed as EUR-positive. However, whilst it also reaffirmed that interest rates are unlikely to be hiked before September 2019, 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.

Hence, if the ECB remains confident about the outlook, the FX market could start to price in an earlier hike in ECB rates. Thus, perhaps over the coming months the market may choose to reposition towards the EUR as it focusses on an ECB on the verge of starting a rate hike cycle and a Fed whose hiking cycle should be drawing to a close.

Low risk appetite should continue to weigh on the EUR. Concern remains focussed on Italy, after the Italian government proposed running a 2.4% GDP budget deficit in 2019. The target is bigger than the EU and the market wanted to see, and its announcement put pressure on the BTP-Bund spread, which quickly spilled over to the EUR.

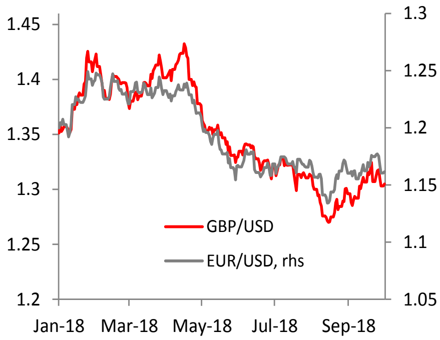
Plus, trade tensions and their impact on global growth are still viewed as USD-positive, even after the US, Canada and Mexico agreed a new trade deal. Nevertheless, we reiterate that we do not believe that a protectionist US administration will want the USD to strengthen too much from its current level.

GBP – A ticking clock

We still feel that the pound is vulnerable to UK political/Brexit uncertainty. The UK's economic data have improved, but the growth outlook remains subdued and we think that the BoE will keep rates unchanged over the coming months. Sterling is also susceptible to the swings in USD sentiment, but with the market already very short GBP/USD, positioning may offer some support in the month ahead.

In order of importance, we see four main factors driving the pound over the coming months: 1) Brexit; 2) USD; 3) UK data; and 4) the BoE. First, the negotiations on the UK's withdrawal from the EU should be coming to some form of conclusion by November. However, as we highlighted in GBP and the Brexit countdown – What's in the box?, published 20 August, we think a 'no-deal' Brexit could cause up to a 7% drop in GBP/USD, with smaller losses posted against the EUR

Chart 51: Sterling remains vulnerable to Brexit risks, but a softer USD and better data may help…



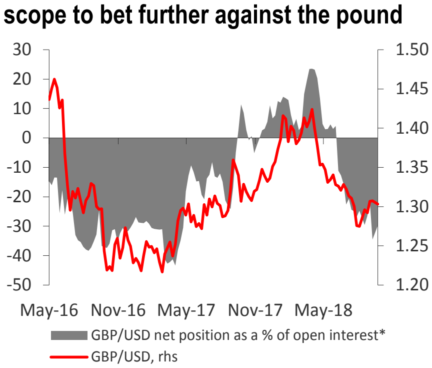
Source: Bloomberg, Santander

The rejection of the PM's 'Chequers plan' at the EU summit in Salzburg in late September has forced the market to take more seriously the chance of 'no deal' between the UK and EU. However, we feel that the market still expects a 'deal' outcome. We think this would boost sterling, but we envisage a gain of only around 3.5% against both the USD and EUR. Further, GBP volatility should remain high as clearer progress on a deal is unlikely before the end of October, or into November.

The market's view on the USD and risk appetite will also remain very important to sterling. A strong US economy, the prospect of more Fed rate hikes, as well as safe-haven dollar demand amid emerging market and trade tension concerns, will remain important. Despite the pound's Brexit focus, USD movements explain much of the change in GBP/USD in 2018, e.g. the correlation between EUR/USD and GBP/USD year-to-date is 0.96.

That said, the pound should find some support from positioning. In our opinion, the pound is already very weak, holding on to much of its post-referendum decline. In addition, speculators still hold a considerable net short GBP/USD position. This implies less scope, even if there is the desire, to bet further against the pound, and therefore may offer some support over the coming weeks.

Chart 52: … plus, with the market still very short GBP/USD, there may be less scope to bet further against the pound



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

Meanwhile, UK economic data have been a little more supportive for the pound. Inflation jumped to 2.7% YoY in August, the labour market remains tight and GDP growth was faster than expected in July. Hence, the BoE now expects growth of 0.5% QoQ in Q3-18, compared to the previous estimate of 0.4%.

Despite the better economic outlook, the BoE kept rates on hold in September, and we continue to expect unchanged interest rates during the months ahead. That said, BoE Governor Carney is reported to have warned the UK government that a 'no-deal' Brexit might lead to an increase in interest rates in an effort to deal with the expected higher inflation, if the pound weakens and tariffs are implemented.

The FX market is sceptical that the governor will hike rates on a 'no deal', particularly if it implies a hit to confidence and growth. In any case, the importance of rate differentials to GBP/G10 crosses has faded recently as the focus has switched to Brexit and/or the USD. Hence, with the pound still vulnerable, we would continue to recommend selling sterling into rallies.

Table 6: G10 FX forecasts

	Q4-18	Q1-19	Q2-19	Q3-19	Q4-19	Q1-20
EUR-USD	1.21	1.23	1.24	1.25	1.26	1.27
GBP-USD	1.32	1.32	1.33	1.35	1.36	1.37
GBP-EUR	1.09	1.07	1.07	1.08	1.08	1.08
EUR-GBP	0.92	0.93	0.93	0.93	0.93	0.93
USD-JPY	118	120	120	120	118	117
EUR-JPY	143	148	149	150	149	149
USD-CNY	6.70	6.80	6.70	6.70	6.70	6.65
EUR-CNY	8.11	8.36	8.31	8.38	8.44	8.45
EUR-CHF	1.20	1.22	1.23	1.24	1.24	1.25
USD-CHF	0.99	0.99	0.99	0.99	0.98	0.98
EUR-SEK	9.9	9.7	9.5	9.3	9.2	9.2
EUR-NOK	9.3	9.1	9.0	8.8	8.7	8.6
USD-CAD	1.22	1.22	1.20	1.20	1.19	1.18
AUD-USD	0.77	0.79	0.80	0.79	0.78	0.77
NZD-USD	0.69	0.71	0.72	0.73	0.74	0.73

Source: Santander

Euro interest rate forecasts

Government Bond yield Forecasts

Bunds	Current	4Q18	1Q19	2Q19	3Q19	4Q19
ECB Refi	0.00	0.00	0.00	0.00	0.30	0.50
ECB Depo	-0.40	-0.40	-0.40	-0.40	-0.20	0.00
3m	-0.54	-0.58	-0.53	-0.40	-0.20	0.00
2y	-0.52	-0.40	-0.20	0.00	0.20	0.40
5y	-0.05	0.05	0.30	0.55	0.75	0.90
10y	0.53	0.65	1.00	1.25	1.40	1.55
30y	1.14	1.25	1.45	1.65	1.85	2.00

Swap rate forecasts

€ swaps	Current	4Q18	1Q19	2Q19	3Q19	4Q19
ECB Refi	0.00	0.00	0.00	0.00	0.30	0.50
ECB Depo	-0.40	-0.40	-0.40	-0.40	-0.20	0.00
3m	-0.32	-0.33	-0.27	-0.17	-0.01	0.22
2y	-0.09	0.00	0.15	0.30	0.50	0.70
5y	0.44	0.50	0.70	0.90	1.10	1.25
10y	1.05	1.15	1.40	1.60	1.75	1.90
30y	1.59	1.65	1.80	1.95	2.10	2.20

US interest rate forecasts

Government Bond yield Forecasts

USTs	Current	4Q18	1Q19	2Q19	3Q19	4Q19
FOMC (mid)	2.125	2.375	2.625	2.875	2.875	2.875
3m	2.21	2.40	2.65	2.90	3.00	3.10
2y	2.89	3.05	3.25	3.40	3.50	3.60
5y	3.07	3.20	3.45	3.60	3.65	3.70
10y	3.22	3.25	3.45	3.60	3.70	3.80
30y	3.38	3.40	3.50	3.55	3.60	3.65

Swap rate forecasts

$ swaps	Current	4Q18	1Q19	2Q19	3Q19	4Q19
FOMC (mid)	2.125	2.375	2.625	2.875	2.875	2.875
3m	2.41	2.55	2.80	3.00	3.10	3.15
2y	3.07	3.20	3.35	3.45	3.50	3.60
5y	3.19	3.30	3.50	3.60	3.60	3.65
10y	3.26	3.30	3.45	3.55	3.65	3.70
30y	3.28	3.30	3.35	3.40	3.40	3.45

UK Interest rate forecasts

Government Bond yield Forecasts

Gilts	Current	4Q18	1Q19	2Q19	3Q19	4Q19
MPC	0.75	0.75	0.75	0.75	0.75	0.75
3m	0.79	0.70	0.70	0.73	0.77	0.77
2y	0.87	0.90	1.00	1.00	1.10	1.10
5y	1.23	1.35	1.40	1.50	1.60	1.65
10y	1.65	1.70	2.00	2.10	2.10	2.20
30y	1.99	2.00	2.40	2.50	2.60	2.65

Swap rate forecasts

£ swaps	Current	4Q18	1Q19	2Q19	3Q19	4Q19
MPC	0.75	0.75	0.75	0.75	0.75	0.75
3m	0.80	0.80	0.80	0.83	0.85	0.85
2y	1.18	1.25	1.35	1.30	1.35	1.30
5y	1.49	1.65	1.65	1.70	1.80	1.75
10y	1.72	1.85	2.10	2.15	2.15	2.25
30y	1.80	1.80	2.20	2.25	2.30	2.35

FX forecasts

	Current	4Q18	1Q19	2Q19	3Q19	4Q19
EUR-USD	1.149	1.21	1.23	1.24	1.25	1.26
EUR-GBP	0.886	0.92	0.93	0.93	0.93	0.93
GBP-USD	1.297	1.32	1.32	1.33	1.35	1.36
USD-JPY	114.3	118	120	120	120	118
EUR-JPY	131.3	143	147.6	148.8	150	149

	Current	4Q18	1Q19	2Q19	3Q19	4Q19
NZD-USD	0.65	0.7	0.7	0.7	0.7	0.7
USD-CAD	1.288	1.22	1.22	1.20	1.20	1.19
AUD-USD	0.71	0.8	0.8	0.8	0.8	0.8
EUR-CHF	1.139	1.20	1.22	1.23	1.24	1.24
EUR-SEK	10.38	9.9	9.7	9.5	9.3	9.2
EUR-NOK	9.46	9.3	9.1	9.0	8.8	8.7

IMPORTANT DISCLOSURES

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

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EXPLANATION OF THE RECOMMENDATION SYSTEM

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

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

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

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

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