29 September 2017, 15:00 CET

Interest & Exchange

Monetary Conditions & Asset Prices: Think Global

Global Strategy: With the BoE probably joining the Fed in hiking rates and the latter starting to reduce its balance sheet already in 4Q17, it could be argued that this gradual normalization of monetary policies should impact financial assets' prices, especially rates. Yet it is also worth keeping in mind that the net supply of (basically free) cash by the ECB and BoJ will more than offset the Fed's reduction in coming quarters, thus limiting the speed of any possible normalization in the price of these assets.

US Macro: The recent increase in nonfinancial private sector debt levels has raised concerns about the possibility of a negative economic scenario ahead, now that the Fed is tightening monetary conditions. In our view, the income and balance sheet positions of both households and nonfinancial corporations is strong enough to deal with any monetary tightening in the short run, minimizing the probability of a negative economic impact.

US Rates: The September FOMC unveiled that the Fed's balance sheet reduction measures will not significantly change the planned pace of Fed Fund hikes, so we see a considerable risk of wider monetary policy repricing. Also, the latest dot chart questions whether the very long end can remain capped by the Fed's longer-run projections. We see value in paying the 2y2yand in tactical steepeners in 2s10s.

EUR Macro: Exports' surge was crucial in consolidating the recovery in the region and they continue performing very well, even in a context of euro appreciation. We believe that the sensitivity of the Euro zone growth to the euro's appreciation is limited in a conjuncture where fundamentals for domestic demand remain quite favourable and the global trade is gaining traction.

EUR Rates: Policy normalisation outside the Euro area the primary driver in a low-vol EUR rates market. Low inflation expectations suggest that ECB will not end or rapidly taper its APP but rather announce an extension on 26 October. Slowly rising rates suggest ongoing focus on positive-carry, value trades. Notwithstanding political noise, growth is robust in periphery sovereigns and we maintain an overweight recommendation.

GBP Macro: Shift in MPC rhetoric leads us to expect a November rate hike, but we still regard the case for higher rates as unconvincing, and expect a single rate hike (0.25%-pt), rather than a tightening cycle. We see concerns around the economy's supply potential, highlighted by recent labour data, as motivating the shift in rhetoric.

GBP Rates: The UK front end has not steepened anywhere near as much as we would have expected given the sharp adjustment in short rates, and we find the 5y region particularly vulnerable if the MPC acts as expected. Over longer trading horizons and tenors, we see bearish pressures from other markets as remaining in place. UK rates should therefore continue drifting higher, but only gently as vast excess reserves continue to support bonds and depress term premia.

G-10 FX: The USD should firm, reversing some recent losses, as a December Fed hike now seems likely. We are positive the EUR into 2018, but feel that some of the recent gains may have been overdone. The ECB should adopt a less dovish policy, but its stance is set to remain looser than other CBs. We have raised our near-term GBP view to reflect the jump in spot as the BoE prepares to hike. But, Brexit uncertainty still implies downside risk in 2018.

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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 expect GDP to come in at 2.2% for 2017E, with GDP growth rates at above 2.5% QoQa in 2H17E. Hurricanes and fiscal reform are the main risks to this scenario.	GDP could grow by 2.2% in 2017E (higher than the 2.0% we expected previously). Revisions to previous quarters' numbers would be behind this upside risk.	We expect slow growth through end-2017, as Brexit uncertainty weighs on investment and a real income squeeze hits consumers. We do not see exports as capable of offsetting weaker domestic demand.
Monetary Policy / Front-End	In spite of the start of the b/s reduction, the Dec'17 hike remains on the table. Especially if core CPI rebounds and/or any fiscal plan goes through..	We still believe the ECB will reduce its bond purchases from Jan'18, but the chosen mix of amount and time of this tapering could depend on the EUR's FX strength.	The shift in rhetoric now suggests a November rate hike, but weaker inflation in H1-18 is expected to reduce the case for further action. We expect Bank Rate to remain at 0.5% through 2018 and no change in QE.
Rates / Duration	The hawkish September FOMC should help US rates fend off recent lows. UST-bearish factors persist, we expect US rates to move gradually higher.	The robust growth, low inflation environment suggests very gradual policy normalisation outside the EA and a modest extension of the APP by the ECB. In turn, that means the rise in term rates will be very slow.	UK rates have continued to drift higher, and should now depend on data and cues from other markets. We see the US-UK rate gap as too tight.
Curve / Slope	The FF and ED curves look too flat. Further out the curve, we think additional flattening is possible (receive 1s3s5s 1y fwd as a carry-efficient alternative to 2s10s flatteners)	Curve slope in EUR remains strongly positively correlated to direction. We expect modest steepening.	Hike pricing is very front-loaded, so the front end can steepen further (e.g. 1y1y/3y1y or 2s5s). 5y remains particularly vulnerable to further sell-offs..
Spreads	Gradually unwinding SOMA reinvestments pose a risk for USTs. We like swap spread wideners (bearish USTs).	Despite political risk, economic recovery and successful financial repression by the ECB underpin periphery spreads, which can tightened further or at least provide better carry.	10y gilts have led the sell-off so far, pushing 5s10s gilts very steep on ASW. 15-20y gilts' recent strength is fading as supply approaches.
Volatility	Recent market changes pushed implied vols higher. The top-left corner still looks low vs. delivered, but the move looks overdone in short-term vega	With the ECB viewed as ultra-cautious and low realised vols, not even rising non-EUR policy rates can push implied vols above the lower portion of their recent range.	Implied vols have eased back alongside daily realized volatility, and remain surprisingly low beyond 5y tenors.
Inflation / Break-evens	BEs continue to inch higher, as we expected. Trend should continue if core CPI shows signs of rebounding.	Though inflation acceleration remains very gradual, 10y ILS levels (1.45%) near accruing actual inflation (1.1% core, 1.5% headline) make long-inflation positions cheap to hold.	UK CPI set to peak around 3% in Q3-17, and we forecast a sharper deceleration in H1-18 than the MPC currently expects. Lack of ultra-long linker supply should help long BEs.
FX	USD has picked up as the Fed signalled it is on course to hike in Dec 2017. Political issues are still a worry, but yields should keep the USD firm.	The EUR/USD uptrend that began in May seems to have ended. The pair should edge lower into the end of the year as risk eases and the Fed hikes.	Sterling has rallied on expectations that the BoE will hike rates over the coming months. However, Brexit uncertainty is still expected to weigh on the economy and GBP in 2018.
Main Risks (to our views)	Sizeable deceleration of Chinese economy. EM assets' reaction to the Fed's initial adjustment, in a structurally more illiquid market.	Even after the French presidential election, political, economic and financial uncertainty remains relatively high, with 'risk' markets priced for a continuation of the positive trend.	A shock forces the MPC to swiftly abandon its newly hawkish stance. Political gridlock within the government or Brexit negotiations. Unexpected acceleration in wages.

Source: Santander Economics, Rates and FX Strategy Research. For a full list of contributors, please see contact details on page 37.

Global Strategy; Monetary Tightening? Not So Fast

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- **With the BoE probably joining the Fed in hiking rates and the latter starting to reduce its balance sheet already in 4Q17, it could be argued that this gradual normalization of monetary policies should impact financial assets' prices, especially rates.**
- **Yet it is also worth keeping in mind that the net supply of (basically free) cash by the ECB and BoJ will more than offset the Fed's reduction in coming quarters, thus limiting the speed of any possible normalization in the price of these assets.**

Table 1: Real GDP growth expectations (and changes)

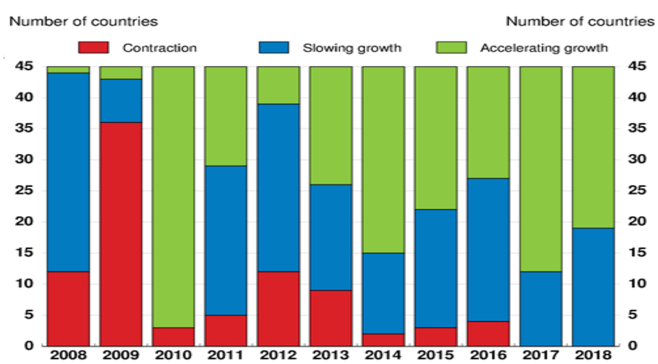
	2017	vs June	2018	vs June
World	**3.5**	0.0	**3.7**	0.1
US	**2.1**	0.0	**2.4**	0.0
Euro	**2.1**	0.3	**1.9**	0.1
Germany	**2.2**	0.2	**2.1**	0.1
France	**1.7**	0.4	**1.6**	0.1
Italy	**1.4**	0.4	**1.2**	0.4
Japan	**1.6**	0.2	**1.2**	0.2
Canada	**3.2**	0.4	**2.3**	0.0
UK	**1.6**	0.0	**1.0**	0.0
China	**6.8**	0.2	**6.6**	0.2
India	**6.7**	-0.6	**7.2**	-0.5
Brazil	**0.6**	-0.1	**1.6**	0.0
Russia	**2.0**	0.6	**2.1**	0.5

Source: OECD, Santander

The macro outlook has barely changed. The still-substantial easy monetary policy environment continues to support global financial markets, despite the recent news from both the BoE and the Federal Reserve. We think this macro environment is still supportive for global financial markets as, acknowledging the present high valuations, the risk of a substantial quick correction appears limited as it is hard to find a clear trigger. In fact, another factor supporting this complacent environment is the extent of the global growth recovery, as well as its synchronicity. We find it interesting that the latest OECD's interim economic outlook expects all its country members to post growth both this year and next (Chart 1), for the first time since the financial crisis. Furthermore, this recovery is not only broad-based but the level of global growth also seems extremely stable, in terms of both pace and country composition (Chart 2), with much smaller imbalances than before the crisis. And all this combines to help reduce the volatility on the macro front and, therefore, in financial markets.

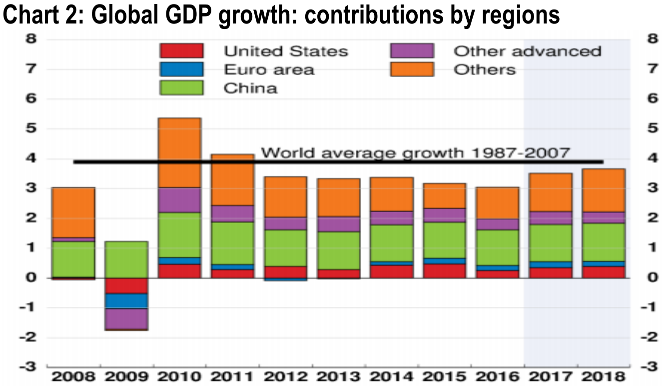
The country breakdown (Table 1) shows India to be the only large country where growth expectations were revised lower (although from a high level), while the three largest Euro countries saw substantial upward revisions. Indeed, the only advanced economies where growth has not been revised higher in the last six months are the UK and the US, whose monetary authorities are moving to gradually unwind their previous monetary easing

Chart 1: GDP Growth in OECD countries



Source: Santander, OECD

Chart 2: Global GDP growth: contributions by regions



Source: OECD, Santander

BoE: a growing –not silent– majority

The BOE seems to be planning a very gradual removal of its previous easing (UK Base Rate was 5% in Sep'08), taking monetary policy to a -slightly- less accommodative stance.

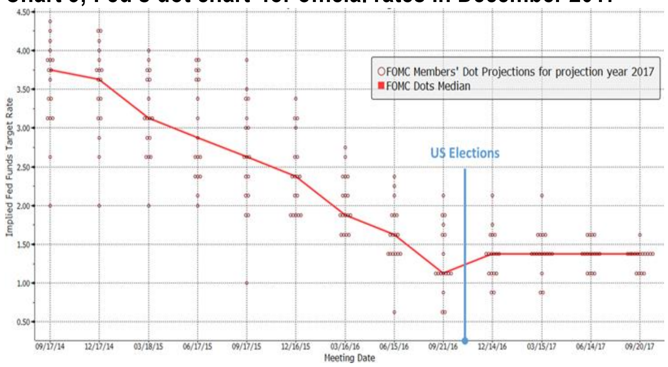
In the UK, and despite the significant Brexit-related uncertainties, a growing majority of **MPC members** seem to believe the time has come to start removing a fraction of the monetary policy easing carried out during the crisis, as they see the **output gap** slowly closing. Indeed, given the 7:2 vote split in the last MPC meeting, and subsequent comments from Carney and Vlieghe, it seems that, unless economic data releases come out clearly weaker than expected, a majority of MPC members could favour a rate hike already on 2 November (page 21). It could be argued that the MPC would just be trying to 'reverse' the post-Brexit referendum cut (-25bp in August 2016), as the macro implications of this vote do not –at least so far– seem to have been as bad as initially feared, but we doubt that is what they are thinking now.

Fed's 'double whammy'?

While it was clear the Fed would skip September in its recent quarterly hike pattern, when they met last month most FOMC members maintained their expectation of another hike in the Fed Funds target rate before year-end, the first with the balance sheet reduction program already in place.

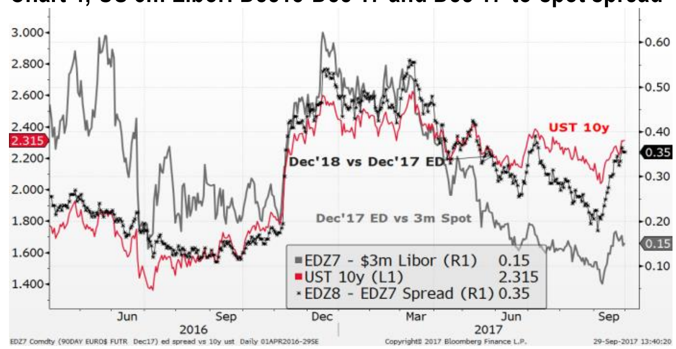
We continue to believe this will depend on whether US core inflation stops surprising on the downside and/or the recent announced fiscal easing program finally materializes. At the end of the day, many FOMC members 'added' an extra hike to their projections after Trump's victory (Chart 3).

Chart 3; Fed's dot chart for official rates in December 2017



Source: Santander, Bloomberg

Chart 4; US 3m Libor: Dec18-Dec'17 and Dec'17-to-spot spread



Source: Santander, Bloomberg

Impact on rates

That said, independent of when the next hike does take place, and even after the recent correction, **we still believe the ED curve is too flat**. Indeed, helped by the recent decline in USD , we believe the Fed will probably raise rates by 75-100bp by the end of 2018 (we are more dovish than the Fed, but more hawkish than the market, see margin table). That said, given the significant changes in the composition of the Fed's board, any medium-term Fed funds forecast should be taken with a pinch of salt.

Table 2: Market implied Probability of Changes in Fed Funds

FOMC Meeting date	fwd eff FF	Probability of 25bp changes 0	1	2
Nov 01, 2017	1.20%	72%	28%	-
Dec 13, 2017	1.32%	24%	76%	-
Jan 31, 2018	1.34%	16%	84%	-
Mar 14, 2018	1.39%	-	96%	4%
May 02, 2018	1.43%	-	80%	20%
Jun 13, 2018	1.49%	-	56%	44%
Jul 25, 2018	1.50%	-	52%	48%
Sep 19, 2018	1.56%	-	28%	72%
Oct 31, 2018	1.58%	-	20%	80%
Dec 12, 2018	1.58%	-	20%	80%

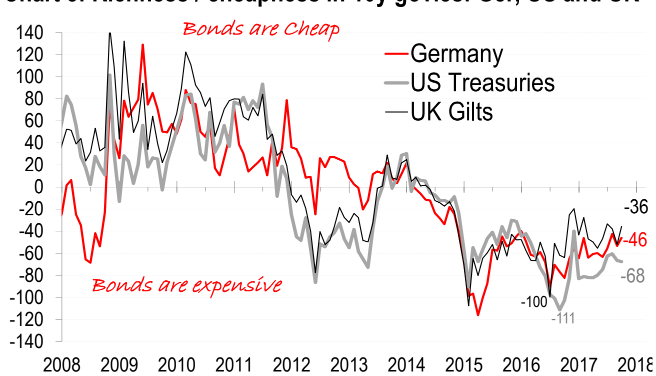
Source: Santander, Bloomberg

Canaries in a coalmine?

So, it seems that the two central banks that dramatically eased their (conventional and non-conventional) monetary policies almost immediately after the implosion of the great financial crisis have started to slowly remove part of that easing, with the obvious concern for financial assets, especially those targeted by these monetary authorities, i.e., government bonds.

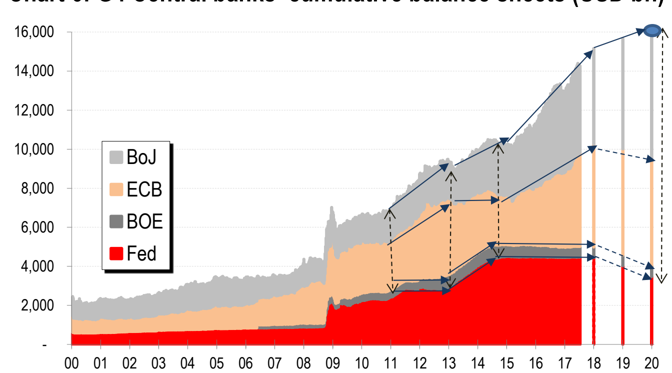
Acknowledging that government bonds are still trading fairly rich vs fundamentals for these reasons (Chart 5), and that this richness should tend to slowly correct, it is also true that **other large central banks, namely the ECB and BoJ, will keep quite easy monetary conditions for quite some time**. Given the international nature of yield-searching flows, this should extend the correction period for this over-valuation of govies/rates.

Chart 5: Richness / cheapness in 10y govies: Ger, US and UK



Source: Bloomberg, Santander , IMF

Chart 6: G4 Central banks' cumulative balance sheets (USD bn)



Source: Bloomberg, Santander, CBO

Monetary Policy = p * q

<u>Conventional</u> monetary policy remains fairly easy, with the average 3m interbank rate in EUR, USD, GBP and JPY at 30bp

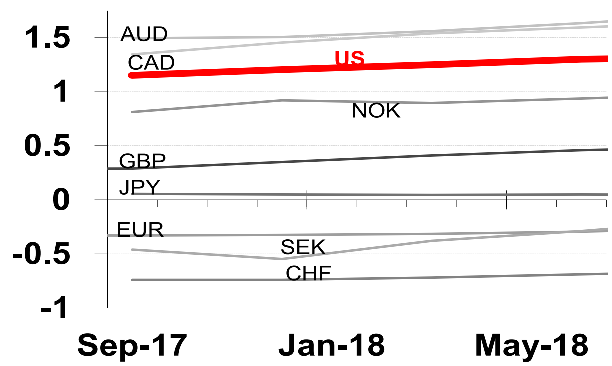
<u>Forward guidance</u>: this average interbank rates is expected to increase to 'only' +65bp by the end of next year

<u>Non-conventional monetary policy:</u> The expected increase in ECB and BoJ balance sheets will more than offset the decline in the Fed's in 2018.

Turning to the **Price of money (p)** –and its time value–, despite the above-mentioned changes in expectations for the BoE's and Fed's policies, the average three-month interbank rate in the world's largest four markets is still 30bp, and would rise to just +64bp considering the rates discounted to the end of 2018 (+2.2bp per month). Furthermore, if we widen the spectrum to other AE, the outlook does not change much as, although some commodity-related countries' (CAD, AUD) short-term rates are slightly above the US's, those in other large European countries (SEK, DEK or CHF) are lower than in Japan and the Euro area (Chart 7).

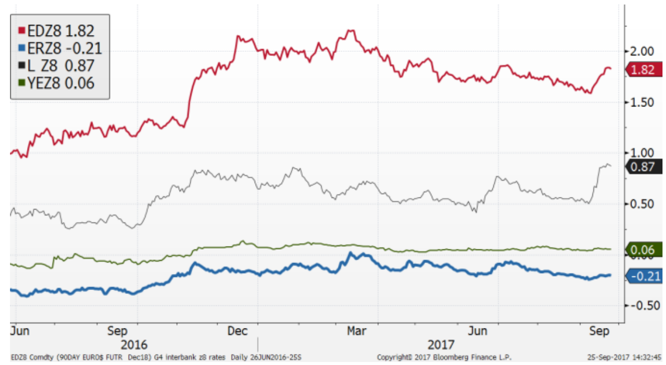
Equally as important –if not more so– as the price of money is its **Quantity (q)**. There were no surprises last month about the speed at which the Fed is about to start slimming its balance sheet. In any case, depending on mortgage prepayments and the maturity of the bonds purchased in upcoming reinvestments, the Fed's balance sheet will still exceed $3trn in 2020, i.e., three times larger than its pre-crisis level.

Chart 7: Short-term interbank rates in large economies



Source: Bloomberg, Santander

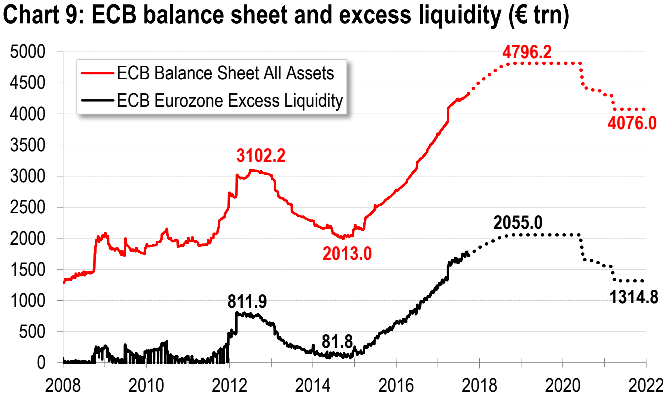
Chart 8: 3m interbank rates discounted for December 2018



Source: Bloomberg, Santander

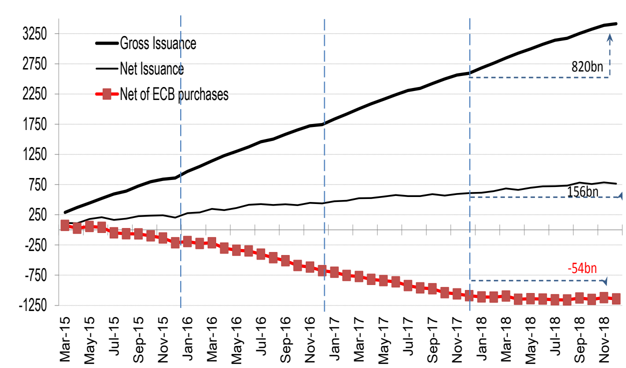
With the BoE probably still far from considering any reduction in its APF portfolio, the monetary expansion focus shifts to the **ECB** and the **BoJ.** As commented previously, the EUR's recent strength is likely to prolong the ECB's asset purchase period beyond its own earlier expectations. **We estimate the ECB will buy another c.€500bn of assets in the next 12 months**, taking its EAPP to €2.6trn and its balance sheet to c.€ 5trn (Chart 9). As discussed in the past, this figure is even more significant when compared to a net supply of EUR government bonds of c.€200bn next year.

Chart 9: ECB balance sheet and excess liquidity (€ trn)



Source: Bloomberg, Santander

Chart 10:EUR govies gross & net supply of bonds after APP



Source: Bloomberg, Santander

For its part, **the BoJ** did not make any changes to its monetary policy or bond buying program in its recent meeting, despite reverse auctions having become the main tool for its 'yield curve target'. With 10-year JGBs trading below 10bp since January 2016 and Japanese investors still keen to look elsewhere in search of extra yield, we believe the BoJ will also contribute to keeping global long-dated yields below fair value for quite some time.

So, while it can be argued that these first ‘baby steps’ in normalizing (some) advanced economies' monetary policies should have a mild impact on financial asset prices, especially in rates, it is also worth keeping in mind that **the net supply of (free) cash from the ECB and BoJ will more than offset the Fed's reduction in coming quarters, thus limiting the speed of any possible normalization in the price of these assets.** In equities and credit, any potential correction would also be affected by the improving global macro and financial conditions mentioned earlier.

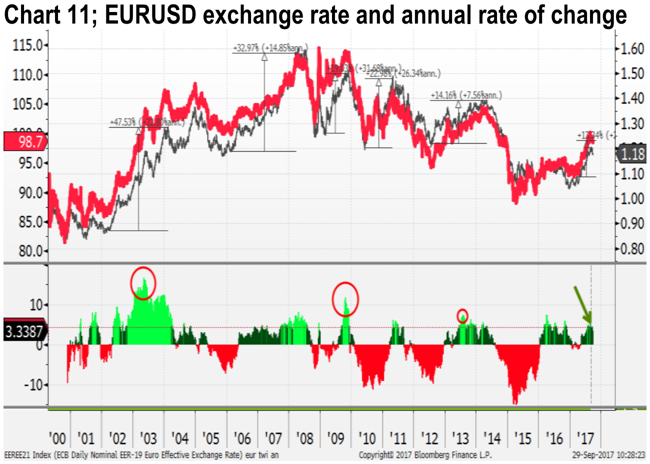
ECB – Relief as the EUR stabilises

At the latest ECB meeting, Mario Draghi was able to keep the EUR exchange rate basically steady, despite offering very little extra news on any further additional easing. As mentioned last month, with its two preferred tools to fight ‘excessive currency appreciation’ being exhausted (official rate cuts and liquidity provisions), the ECB is basically left with forward guidance to avoid excessive EUR appreciation, while waiting for a possible BoE hike and US fiscal easing plan to take some wind out of the EUR’s sails.

The transmission of the ECB’s monetary policy in standard and non-standard times,
B. Coeure 11 September 2017
https://www.ecb.europa.eu/press/key/date/2017/html/ecb.sp170911.en.html

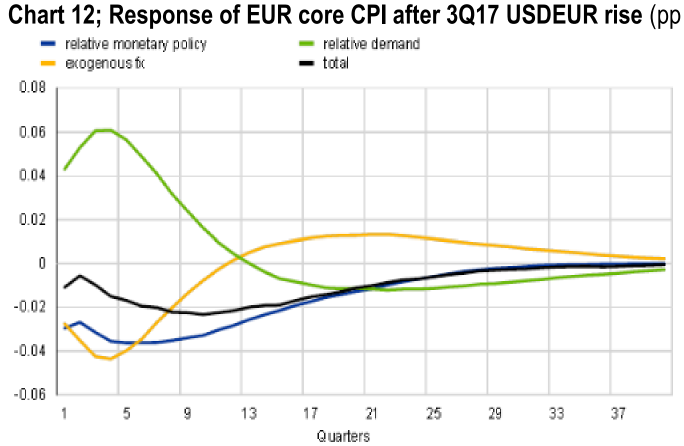
We continue to believe the ECB is not that concerned about the EUR’s current level as not only it is still below its post-EMU (and last ten-year) average (Chart 11) but, once we take into account both the endogenous (economic recovery and relative monetary policy) and exogenous factors, the ECB’s own models show the combined impact on the ECB inflation projections is limited, at just 0.2% of inflation vs. trend (Chart 12 and margin). We think the ECB is probably relieved that the post-Sintra rally has stabilised.

Chart 11; EURUSD exchange rate and annual rate of change



Source: Bloomberg, Santander

Chart 12; Response of EUR core CPI after 3Q17 USDEUR rise (pp



Source: Bloomberg, Santander, ECB

That said, given its lack of control over exogenous factors, and in order to avoid another monetary conditions tightening scare –that would further complicate reaching its inflation goal–, we think the ECB is likely to continue using its forward guidance to keep conditions relatively easy, **signalling to the market that any rate hike is still a long way off.**

Table 3: ECB purchase plan; Split by assets and scenarios

	Historical data, EUR bn						
	Avge Jun'16-Mar'17	% of total	Avge since Apr'17	% chg	Scenario 4	% of total	% chg
EAPP target	80.0	100%	60.0	-25%	40.0	100%	-33%
CSPP	7.7	10%	6.4	-17%	5.6	14%	-12%
CBPP3	3.9	5%	2.8	-29%	2.5	6%	-11%
ABSPP	0.5	1%	0.1	-89%	0.1	0%	0%
PSPP	**67.8**	**85%**	**50.8**	-25%	**31.8**	**80%**	-37%
Supras	6.8	8%	5.1	-25%	4.5	11%	-12%
Countries	61.1	76%	45.7	-25%	27.3	68%	-40%
Agencies *	9.2	11%	6.8	-25%	6.0	15%	-12%
Govies *	**51.9**	**65%**	**38.8**	-25%	**21.3**	**53%**	-45%
Germany	16.7	21%	11.9	-29%	5.3	13%	-55%
Bunds **	**12.9**	**16%**	**7.8**	-39%	**3.5**	**9%**	-55%

Source: Bloomberg, Santander

It should, therefore, extend its asset purchase program for at least another nine months (in one or two instalments), albeit at a slower pace (€30-40bn) as the amount of eligible German bonds is becoming scarcer by the day.

We also believe the Bundesbank will stick to its capital key regarding the share of purchases (contrary to what happens in Italy, France and Spain) and that when the ECB does scale back the average monthly pace of purchases from the current €60bn per month, the split of PSPP (vs CSPP and CBPP) buying will fall (from 85% to 80%) and, within it, that the share of German bonds will also fall vs regions and agencies. Accordingly, we think the amount of German bonds purchased monthly could tumble from the recent €7.8bn average to around just €4bn to avoid these scarcity problems and allow a long extension –in time– of the program.

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The recent increase in nonfinancial private sector debt levels has raised concerns about the possibility of a negative economic scenario ahead, now that the Fed is tightening monetary conditions. In our view, the income and balance sheet positions of both households and nonfinancial corporations is strong enough to deal with any monetary tightening in the short run, minimizing the probability of a negative economic impact.

How concerned should we be about the increase in private sector debt levels?

We have heard recently warnings about the risks of a new increase in private sector debt levels in the US. According to them, we could be heading back to an economic scenario in which high debt levels could represent a real risk for the financial sustainability of both households' and non-financial corporations' balance sheets in a context of tighter monetary policy. In our view, those concerns are not justified since, despite having already seen debt growth rates pick up of (particularly in the case of corporations), they remain at manageable levels from an historical perspective and in relation to other economic variables.

Total debt outstanding still relatively stable as a % of GDP

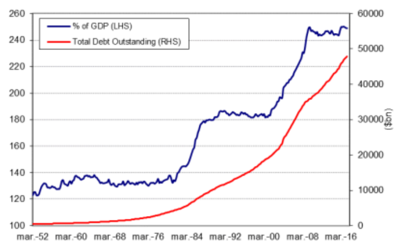
Total debt outstanding in credit instruments reached $66.908trn in 2Q17, up from $52.575trn in 2007. That is, there has been an increase of $14.333trn in total outstanding debt in the last ten years. However, when measured as a percentage of GDP, total debt stands at 348% of GDP in 2Q17 (slightly above the 345% reached in 3Q15) from 358% of GDP in 2007 and a peak of 382% in 2Q09. New borrowing has averaged 10pp of GDP annually since 2007, with this percentage growing to 13% in the last two years. Levels of new borrowing at 10% of GDP are quite low from an historical perspective. As shown in the charts, we would have to go back to 1950-70 to see such low levels of borrowing as a percentage of GDP. Moreover, the public sector accounted for a big part of the increase seen in the last ten years.

In the case of the nonfinancial private sector, numbers have actually improved in recent years:

(1) Corporates increased their debt outstanding in credit instruments (45.6% of total liabilities of nonfinancial corporations) to $8.718trn in 2Q17 from $6.050trn in 2010 (the lowest level since the adjustment) and $6.638trn at the peak of the previous economic cycle in 3Q08. Borrowing has been at 2.0% of GDP in the last two years, while the stock of debt has reached 45% of GDP, also the level seen at the peak of previous cycles. Total outstanding debt has grown by an average of 6.0% in the last two years, but decelerated to 5.5% in 2Q17.

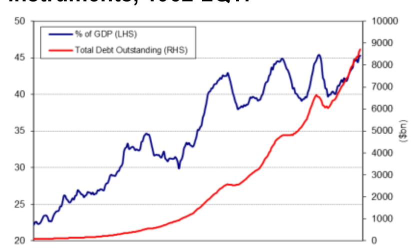
(2) Households' outstanding debt in credit instruments (97.6% of their total liabilities) reached $14.912trn in 2Q17, from $13.382trn in 3Q12 (the lowest since the peak of $14.364trn in 3Q08). As a percentage of GDP, total outstanding debt in credit instruments was a low 77.5% in 2Q17 from a peak of 97.7% in 1Q08. 2Q17 debt outstanding as a percentage of GDP is at the same level as it was in 2002. New borrowing is growing quite modestly (3.0% of GDP in the last two years) versus more than 5% of GDP in the previous cycle. The breakdown of households' debt outstanding also shows that most of that debt is home mortgages (67% of total debt outstanding), which stood at $9.923trn (51.6% of GDP) in 2Q17 from a peak of $10.705trn in 2Q08 and 74% of GDP in 2Q09. Mortgage debt levels as a percentage of GDP are now at the same levels as in 2002. Looking at the borrowing numbers, they grew by 6.0% of GDP in the 2000-07 period, while the rate has been just 1.3% for the last two years. That is, growth levels are still quite low versus previous economic cycles and point to further stability in debt-to-GDP levels in the short run. What is really growing in households' accounts is consumer credit. Consumer credit debt outstanding reached

Chart 13: Total outstanding debt in credit instruments, 1952-2Q17



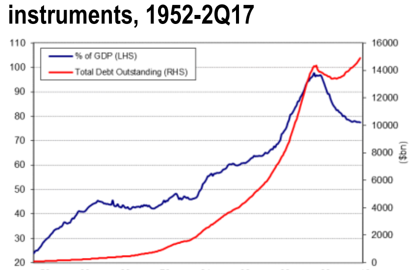
Source: Datastream and Santander.

Chart 14: Nonfinancial corporations total outstanding debt in credit instruments, 1952-2Q17



Source: Datastream and Santander.

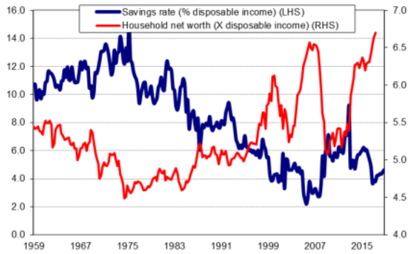
Chart 15: Households' total outstanding debt in credit instruments, 1952-2Q17



Source: Datastream and Santander.

$3.735trn in 2Q17, which is the highest level ever, well above the $2.519trn posted in 3Q10 (after the modest adjustment seen from the peak of the previous economic cycle). Consumer credit represented 19.4% in 2Q17, also the highest level ever. Borrowing numbers show that the flow of consumer credit has been growing by c.$220bn annually since 2014 ($170bn in 2Q17) which is a modest number (0.9%) when calculated as a percentage of GDP, particularly considering that the historical average since 1950 is 1.0%. As we explained in our last Interest & Exchange report, households have been using consumer credit to keep fuelling consumption growth in recent quarters, since income did not help too much in that period.

Chart 16: Households' net worth vs savings (as a X/% of GDI), 1959-2Q17

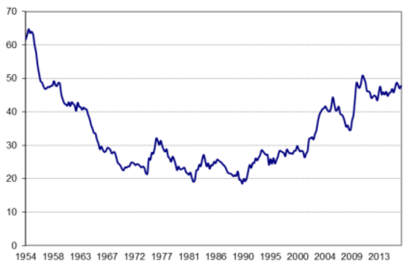


Source: Datastream and Santander.

Households' income and balance sheets strong enough to deal with current debt levels

Although households' outstanding debt levels, in particular those corresponding to consumer credit, have gone up in recent years, the performance of their income metrics and balance sheets minimises the probability of a debt crisis. Note that personal income has grown by 3.1% in the last two years, with disposable income up by 3.0% in the same period. The savings rate, despite having dipped recently, was at 3.7% of GDI in 2Q17, exceeding the levels reached in 2005-07 (2.9% of GDI). Capital expenditures remain very low (11.0% of GDP) from an historical perspective and households' financing gap showed a surplus of $366bn (average of last four quarters) in 2Q17, which would represent 2.5% of GDI and 1.9% of GDP (RECALL that households ran a huge negative financing gap in the 2000-07 period, with major investments in residential assets)

Chart 17: Nonfinancial corporations' liquid assets/short-term liabilities, 1954-2Q17



Source: Datastream and Santander.

As a result, when we calculate debt as a percentage of GDI, we find that (taking all households' liabilities, $15.219bn in 2Q17) it was at a relatively low 106.1% in 2Q17, which is the same level as back in 2002. Debt service ratios are also very low (see our last Interest & Exchange) and far from the levels seen before the past crisis. Finally, net worth ($96.196trn in 2Q17) is at its highest ever, both in absolute terms and as a percentage of GDI (6.7x GDI in 2Q17)

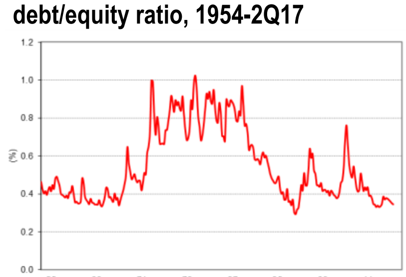
Chart 18: Nonfinancial corporations' short-term debt/total credit market debt, 1954-2Q17

Source: Datastream and Santander.

Nonfinancial corporations increased debt levels, but their balance sheets and their income are also strong

Total liabilities reached $19.154trn in 2Q17, which represents 99.5% of GDP (the highest level ever) At the same time, total assets also climbed, hitting $20.706trn in 2Q17 (107.6% of GDP), also the highest ever, both in absolute terms and as a percentage of GDP. Analysing the debt structure and balance sheet position shows the current debt position to be manageable. We note that: (1) the market value of equities is high ($25.306trn); (2) total short-term liabilities amount to $4.719trn, versus $2.256trn of total liquid assets –i.e., the ratio of liquid assets over short-term liabilities was 47.8% in 2Q17– (almost the highest ever); (3) long-term debt represents 72.3% of total credit market debt, with short-term debt as a percentage of total credit at nearly the lowest ever (27.7%); and (4) total net worth has reached $23.294trn, taking the debt-to-net worth ratio down to similar levels to those of the debt-to–equity ratio (close to their lowest ever). In summary, we see the current levels of US debt as being manageable.

Chart 19: Nonfinancial corporations' debt/equity ratio, 1954-2Q17



Source: Datastream and Santander.

US Rates Strategy: FOMC still committed to further hikes

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- **The September FOMC unveiled that the Fed's balance sheet reduction measures will not significantly alter the planned pace for the Fed Funds rate. The door remains wide open to a 25bp hike in December, followed by more in the coming years.**
- **In spite of some repricing after the FOMC meeting, the market continues to price in a much shallower tightening. We see a considerable risk of wider monetary policy repricing.**
- **On the shape of the curve, the latest dot chart questions whether the very long end can remain capped by the Fed's "longer-run" projections. Additionally, macro expectations are improving, paving the way for some resteepening in 2s10s.**

Table 4: Expected reduction in the Fed's SOMA portfolio

	Not reinvested in USTs ($ bn/month)	run-off in MBSs ($ bn/mont	Fed's B/Sht ($ trn)
3Q17	-	-	4.52
4Q17	6.0	4.0	4.49
TOTAL 2017	**18.0**	**12.0**	**-1%**
1Q18	12.0	8.0	4.43
2Q18	18.0	12.0	4.34
3Q18	24.0	16.0	4.22
4Q18	30.0	20.0	4.07
TOTAL 2018	**252.0**	**144.0**	**-8%**
1Q19	29.0	19.4	3.92
2Q19	30.0	20.0	3.77
3Q19	29.2	19.4	3.63
4Q19	22.8	15.2	3.51
TOTAL 2019	**333.1**	**164.0**	**-10%**
1Q20	20.0	13.3	3.41
2Q20	22.6	15.1	3.30
3Q20	21.3	14.2	3.19
4Q20	8.3	5.5	3.15
TOTAL 2020	**216.5**	**104.4**	**-8%**
1Q21	19.4	13.0	3.05
2Q21	22.0	14.7	2.94
3Q21	11.3	7.5	2.89
4Q21	13.1	8.7	2.82
TOTAL 2021	**197.5**	**92.8**	**-8%**

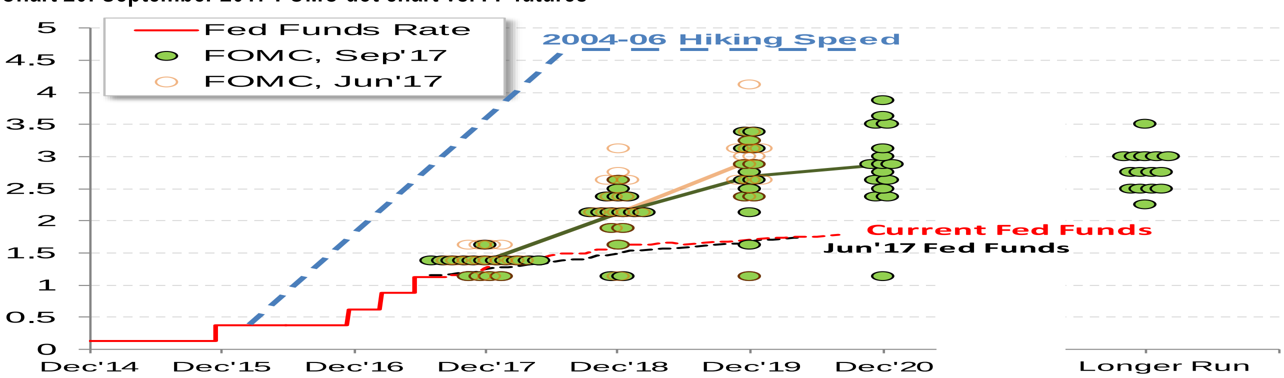
Source: Federal Reserve, Bloomberg, Santander..

Balance-sheet reduction will not significantly change the planned pace of hikes…

As widely expected, in the September FOMC the Fed announced the beginning of its balance sheet reduction measures (starting in October), while maintaining official US rates unchanged at 1.00-1.25%. But, as we discussed in detail in our FOMC post-mortem, included in the 21 September MMD, the updated dot chart clearly offers a much more hawkish view than that priced in by the market, even if does contain some downward revisions to the FOMC's FF projections in 2019 and beyond. This highlights that there is ample room for a wider repricing in monetary policy expectations in the months to come.

First, and most evidently, the pace of hikes projected for the next few years is mostly unchanged vs. that in previous quarters. This is a hawkish sign because not only do the FOMC members continue to see another hike before the end of the year as appropriate (only 4 of the 16 members think the Fed should stay put, see Chart 20), but also because these updated projections reflect that the introduction of the balance-sheet reduction measures should not significantly alter the planned pace of rate hikes. This is significant because, as discussed in previous editions of this report (see our 30 June I&E), the tightening in monetary conditions caused by the Fed's balance-sheet reduction should be equivalent to around 75bp in FF rate hikes between now and the end of 2019. It is difficult to ascertain the previous probability the FOMC members assigned to these balance-sheet reduction measures starting in 4Q17 already (and, therefore, how much of this 'substitutive' tightening was already priced in to previous dot charts). But the market read the fact that the new FF projections have barely changed as a hawkish sign. Not to mention that the market continues to price the FF rate around 100bp lower in 2019 than the dots (with 14 of the 16 FOMC members expecting the FF rate to be higher than currently priced in, both in 2018 and 2019).

Chart 20: September 2017 FOMC dot chart vs. FF futures

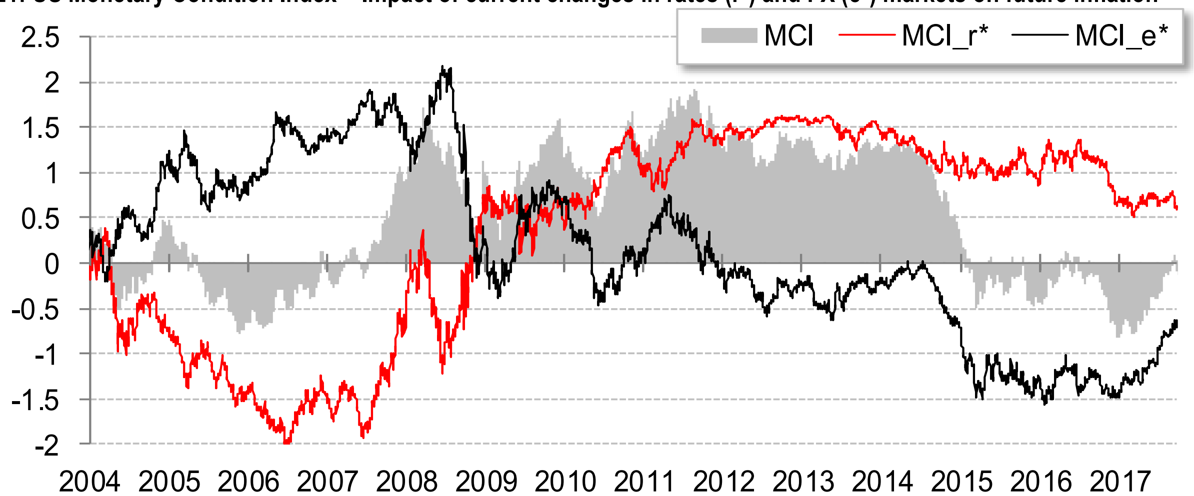


Source: Bloomberg, Santander.

As we have discussed in previous editions of this report, we believe that macro conditions in the US remain healthy enough to let the Fed continue with the gradual normalization of its monetary policy. Tail risks (namely geopolitical) and temporary weather-related noise aside, the strong weakening of the USD in recent months and the news from the US government about its fiscal reform should help the FOMC members maintain a sanguine view on the US economy. So, we believe that those dots could very well reflect the actual path of the Fed Funds rate in coming years.

To illustrate the magnitude of the year-to-date movements in the USD, we estimate that its easing impact on US monetary conditions (measured as the expected impact on future inflation) would be similar to the tightening caused by FF hikes in the previous months, with US monetary conditions now being similar to those back in 2015 and 2016. This is shown in Chart 21 where, using the [OECD global model] to translate the interest rate (MCI_R+, red line) and the FX (MCI_E*, black line) components of a simple monetary conditions index into their equivalent impact on future inflation (as measured by the expected YoY change in the next five years, shaded in grey in the chart).

Chart 21: US Monetary Condition Index – Impact of current changes in rates (r*) and FX (e*) markets on future inflation



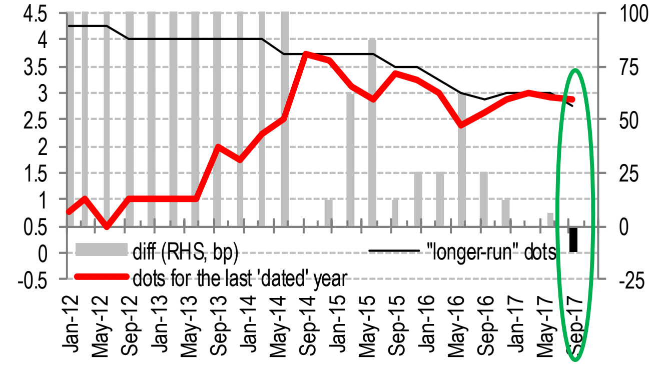
The MCI_r* index (red) represents the expected impact of changes in official rates (1y1y rate), including the direct FX impact (as for historical regression vs the DXY index). The MCI_e* index (black) represents the impact of changes in the exchange rate (DXY) that are not caused by changes in monetary policy expectations. We estimate that the impact on future inflation of a 100bp increase in official rates would be similar to that caused by a 10% appreciation in the DXY (triggered by factors other than domestic monetary policy).
Source: OECD, Bloomberg, Santander.

… And the terminal rate could be actually higher than the longer-run dots

Also, the newly-introduced 2020 dots show that, for the first time since these dots are published (January 2012), most FOMC members think that the FF rate can move above longer-run levels (Chart 22, next page). This is a change that, while it seems to be under the radar, we believe could become very important for the future performance of ultra-long rates.

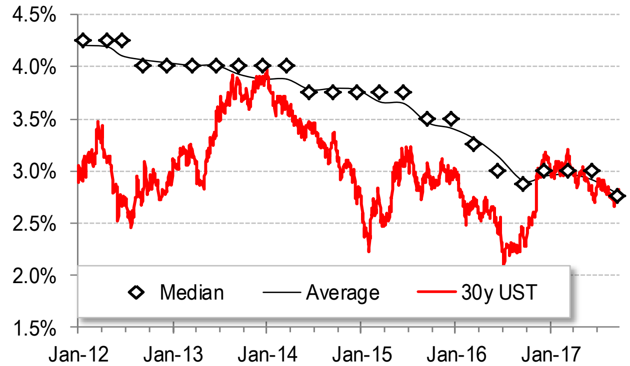
To date, the market has tended to believe that these longer-run dots represented the terminal rate the FOMC members were projecting for the current tightening cycle. Indeed, we have seen these longer-run dots acting as a kind of ceiling for US rates (see Chart 23, next page).

Chart 22: The median of the dots corresponding to the las 'dated' year stands now above the "longer-run" dots



Source: Bloomberg, Santander..

Chart 23: The median of the "longer-run" dots has acted as a cap for US yields

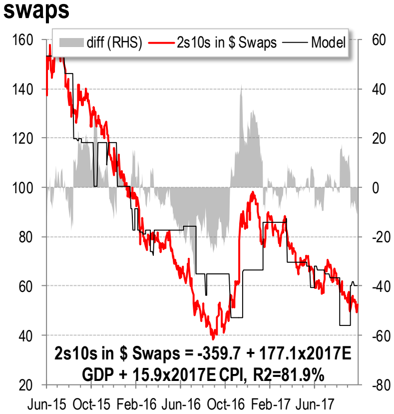


Source: Bloomberg, Santander.

In our view, this assumption might now be called into question, so that ceiling should be softer (or even disappear) for US rates. Therefore, with the long end already close to those levels, we believe this change in the dots could have **implications for the future dynamics of the US curve**.

However,we do not think that a higher FF projection than the longer-run dots will cause an immediate steepening of the US curve by itself (not even in the ultra-long end), even if the 'cap' that currently anchors the ultra-long end is eased somewhat. We continue to think that macro expectations remain an important driver for the shape of the curve and, therefore, tend to see it the other way around: **the 'easing' of this possible cap should be particularly significant in a bear-flattening move**, limiting it as the long end could deteriorate more than previously expected. And that could occur if the Fed goes ahead with additional hikes in the quarters ahead, as we expect. Especially if we see some Congressional support for the proposed the US government has just announced, helping the market build up expectations of higher nominal growth in the US in coming years.

Chart 24: US growth and inflation expectations vs. 2s10s slope in USD swaps



Source: Bloomberg, Santander..

Risks in 2s10s now biased towards a slight steepening

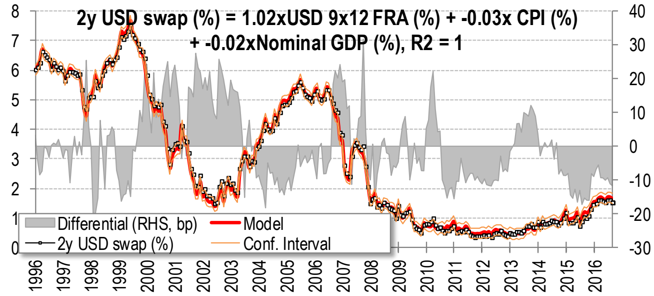
In this connection, last month (see 1 September I&E) we warned that the flattening trend could continue in 2s10s on the back of the ongoing downward revisions to consensus macro estimates for the US. And that slope, which was as steep as 57bp when we published our report, marked a recent low below 50bp on Tuesday.

But consensus expectations have now started to improve, and that means that the risk in the weeks ahead is again biased towards some re-steepening. Our model (Chart 23) suggests that a bounce back to the 60bp area is possible. And the curve might steepen further if, as mentioned before, expectations around the US government passing its fiscal reform increase in the months ahead

We are therefore closing our flattener with gains and would tactically position for some steepening now, looking for this possible correction and also gaining exposure to any possible repricing if the tax reform goes ahead and that helps revamp expectations for the US economy. Outright 2s10s steepeners offer a positive carry and roll-down (of around 5bp in 3 months), so we feel comfortable setting an initial target even slightly above the level suggested by the model, even if that takes longer.

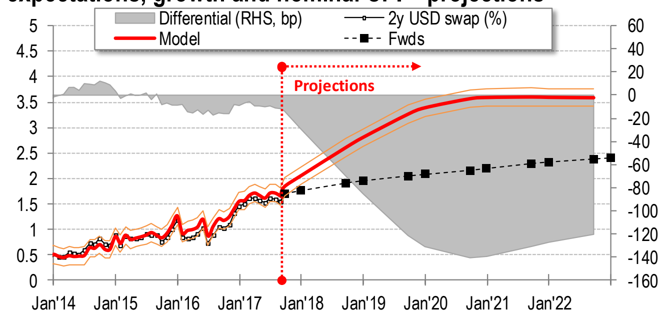
Trade idea: Tactical steepeners in 2s10s
Entry level = 52bp. Target level = 70bp. Stop loss = 45bp
3m carry = 2.4bp. 3m roll-down = 1.9bp

Chart 25: 2y swap rate as a function of monetary policy expectations, growth and nominal CPI – history since 2008



Source: Bloomberg, Santander.

Chart 26: 2y swap rate as a function of monetary policy expectations, growth and nominal CPI – projections



Source: Bloomberg, Santander.

Chart 27: Recent performance of 2y2y USD swap rate

Source: Bloomberg, Santander.

Reinforcing our call of repricing in the very front end

We continue to feel comfortable with our bearish view on the very front end of the US curve, as the FOMC reiterated its view of a faster pace of hikes than the market is pricing. As discussed above, not only does the December 2017 hike remain on the table, but the number of hikes depicted for 2018 and 2019 is way above those expected by the market. In fact, as already discussed last month (see 1 September I&E), we believe there is a lot of value in any position that would benefit from such a possible repricing, like the Z8Z9 steepeners we recommended back then. That trade remains very attractive, in our view, and in this edition we extend our recommendation further out the curve, looking for a broader potential gain.

Fundamental models that have historically succeeded in explaining the market evolution of swaps as a function of monetary policy, growth and inflation expectations (Chart 25) suggest that, if the Fed goes ahead as indicated in the dot chart (taking the median of the dots for each year as the possible level of future FF) and the US economy simply proceeds as the IMF forecasts in its latest macro projections, there is a huge discrepancy between the levels that the model suggest as consistent by that macro and monetary policy environment and current forwards, particularly two years from now (Chart 26).

Looking at the performance of the 2y2y USD swap rate over the past few years (Chart 27), we see that the reflation trade has taken that rate back to the ranges seen in 2013-2015. If the market does start to price in the pace of hikes suggested by the Fed's dot chart, we would expect the 2y2y to, at least, return to the higher end of this range, currently at 2.5%. On the contrary, if the rate trades back below 2% we would re-evaluate the situation.

Trade idea: Pay 2y2y
Entry level = 2.10%. Target level = 2.40%. Stop loss = 2%
3m roll-down = -4bp

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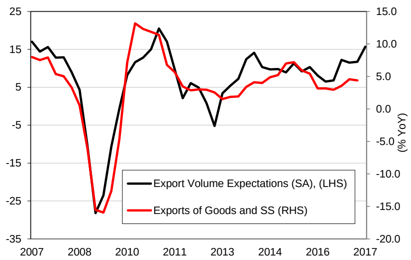
Exports' surge was crucial in consolidating the recovery in the region and they continue performing very well, even in a context of euro appreciation. We believe that the sensitivity of the Euro zone growth to the euro's appreciation is limited in a conjuncture where fundamentals for domestic demand remain quite favourable and the global trade is gaining traction.

Chart 28: Euro zone exports and expectations

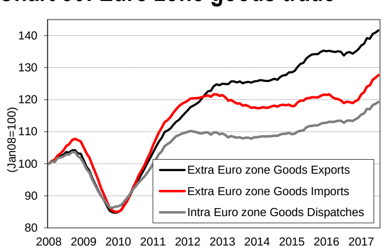


Source: Eurostat, EC and Santander.

Chart 29: Nominal trade-weighted euro exchange rate

Source: BoE and Santander.

Chart 30: Euro zone goods trade



Source: Eurostat and Santander.

The appreciation of the euro has attracted the attention as a factor that could bias the region's GDP growth to the downside through a worsening in the performance of exports. In our view, the consolidation of the domestic demand recovery makes the Euro area more resilient to exchange rate movements than in the past and, in addition, the performance of and expectations for exports continue to be quite encouraging. At the end of the day, suggesting that, effectively, the negative impact of the euro's appreciation is quite limited.

The importance of exports for the economic recovery

The boost from exports has been very important in supporting the Euro zone economy's recovery process. After the collapse in 2009 (-12.3%), total exports of goods and services rebounded in 2010 (+11.1%) and, since then, sales outside the area maintained an average annual increase of c4.0% through 2016. In this connection, the trend in imports from the Euro zone also evidences the recovery by domestic spending. 2009 was a very bad year for imports (-11.2%) but, since then, the annual pace has picked up to around 3.5% and has been particularly strong since 2014 (with imports rising by an average of 5.3%).

That said, Euro zone **trade flows maintained good rates of expansion in 1H17**, in particular in the case of exports. According to the figures released by Eurostat, real exports of goods and services went up 1.3% QoQ in 1Q17 and 1.1% QoQ in 2Q17, that is, accelerating in comparison with the same period of 2016. As a result, the annual rate was at 4.4% YoY in 2Q17, which compares favourably with 3.2% in 2016. The quarterly performance of imports during the first semester of the year has been more modest: 0.4% in 1Q17 and 0.9% in 2Q17. Together with the aforementioned robust trend in exports, this has resulted in the net external sector contributing a positive 0.5pp to the aggregate GDP growth in 1H17 (at a cumulated 1.1%).

The euro's appreciation and export expectations…

Information about the external sector's performance in 3Q17 is still scarce, but concerns about exports worsening have increased due to the strengthening euro. The upward trend initiated by the euro at the end of 2015 has intensified since April 2017 and now amounts to a cumulative appreciation of 6% in terms of the nominal effective exchange rate. Obviously, a stronger euro poses a downward risk for exports, which the European Commission (*Quarterly Report on the Euro Area*, Volume 13, October 2014) estimates have an elasticity of -0.77 to the real effective exchange rate. The most vulnerable countries could be Italy (-2.56), Portugal (-2.14), Spain (-1.61) and France (-1.44), in contrast with Germany (-0.81).

However, **even assuming that the euro's appreciation is a risk for exports, we believe that the possibility of this translating into worsening expectations about the pace of GDP recovery is contained thanks to the positive domestic demand trend.** Euro zone private domestic final sales increased by 2.0% in 2015, by 2.6% in 2016 and, according to the figures already released, by an annual rate of c2.0% in 1H17, that could be even gaining some traction in 2H17. Note that this recovery in domestic spending is driven by improving fundamentals, in other words, it is not transitory.

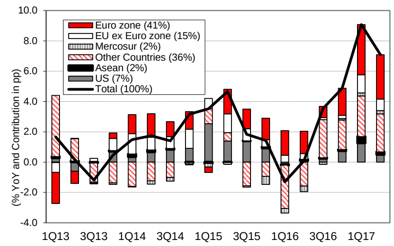
… not so worrying in the end

At this stage, in any case, **it is quite significant that, despite the euro's appreciation, Euro zone companies' external demand expectations have not deteriorated, on the contrary.** Confidence surveys up to

Chart 31: German imports of goods from the Euro zone

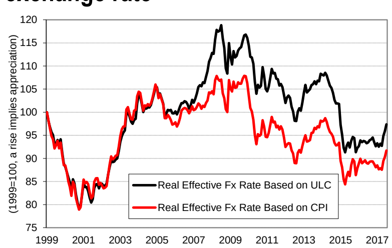
Source: German Statistical Office and Santander.

Chart 32: Italian exports of goods by destination



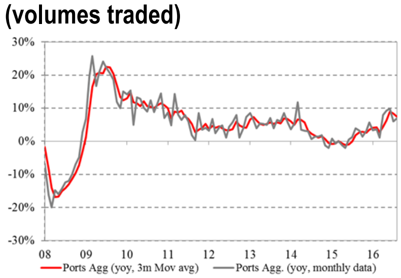
Source: ISTAT and Santander (weight in total in brackets).

Chart 33: Real trade-weighted euro exchange rate



Source: IMF and Santander.

Chart 34: World ports aggregate (volumes traded)



Source: Bloomberg, Datastream and Santander.

September have even surprised positively and, in fact, Euro zone companies point out that export orders could be expanding at their fastest rate since 2011. Sales outside the region are boosting manufacturing activities, in particular, which seem to face capacity constraints and are contributing to higher rates of production, job creation and investments, feeding optimistic expectations about activity in coming months.

At the end of the day, we think that the aforementioned positive evolution of Euro zone exports and expectations ahead are sustained by:

On the one hand, the significance of **intra-euro commerce**, that is, those trade flows not directly affected by euro movements because they are among member countries. In this sense, intra-area goods trade represented c45% of total exports by the region in July and are increasing at a pace above 5.5% YoY. This means that the consolidation of the domestic demand recovery, not only in the countries leading the upturn, such as Germany and Spain, but also in France and Italy, is very good news for the positive externalities it generates among member economies. A good example is Germany, where imports of goods from other Euro area countries have been depicting a very intense upward trend since the end of 2016 and are now increasing by 13% YoY. In fact, the contribution of the Euro zone as a destination of German exports has increased in the last quarters.

On the other hand, and regarding exports outside the Euro zone, we would highlight the fact that the **gains in price-competitiveness achieved by the Euro zone since the year 2008** (mainly in terms of relative unit labour costs after the internal devaluations in the periphery) set a favourable starting point compared with other episodes of euro appreciation because the area should be less vulnerable now. In other words, companies' efforts to offset the negative impact from the strengthening euro to avoid a significant deterioration vs. their competitors could have diminished, courtesy of the adjustment in relative prices and costs during the crisis years.

Another important factor to limit the risks of the euro appreciation is that it is taking place when **global trade seems to be intensifying**. Obviously, this is very important because the European Commission (*Quarterly Report on the Euro Area*, Volume 13, October 2014) estimates Euro zone exports' elasticity to foreign demand at 0.91. So, we would be talking about a significant positive quantity impact on Euro zone exports derived from the revival of demand from important trade partners.

In sum, the sensitivity of Euro zone growth to the euro's appreciation seems to be limited with the fundamentals for domestic demand remaining quite favourable and global trade gaining traction. We expect imports to sustain a solid pace of expansion in coming quarters, supported by the boost from domestic demand. But, we think that the news is that the bulk of the surprises about the performance of exports continues positive, probably because the euro's fast appreciation is being offset by other factors that differentiate the current cycle from previous ones. All in all, we do not anticipate a significant worsening in the net external sector's contribution to the region's GDP growth due to the euro exchange rate movements and we remain positive on the performance of the Euro zone economy in coming quarters (above 2.0% YoY).

Euro Rates Strategy: Super-gradual adjustment in rates suggests ongoing need to focus on positive-carry, value trades

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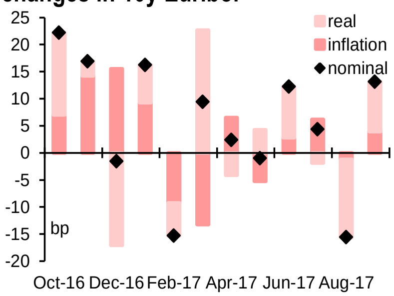
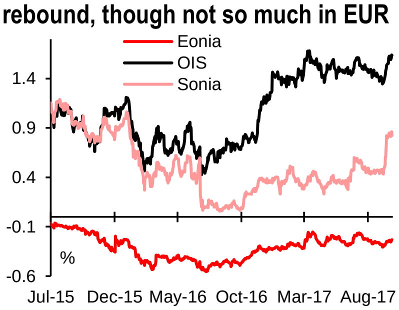
- **Since the Euro area (and G7) economy remains in a robust growth mode, low inflation environment, policy normalisation prospects in the US and elsewhere have been the primary drivers in a low-vol EUR rates market.**
- **Inflation expectations and financial conditions are not such that the ECB will end or rapidly taper its APP, in our opinion. We expect a modest extension to be announced on 26 October.**
- **Notwithstanding a lot of focus on near-term political noise, periphery sovereigns are experiencing strong and/or improving growth. We maintain an overweight recommendation here.**

Chart 35: Composition of m/m changes in 10y Euribor



Source: Bloomberg, Santander

Chart 36: 1f1y O/N swap rates rebound, though not so much in EUR



Source: Bloomberg, Santander

Low-volatility EUR rates responding to other markets

From low late-August levels, EUR rates have sold off somewhat, as might be expected, and are now about 10-15 bp higher. Nonetheless, for EUR core yields and Euribor rates, the **low-volatility, high noise-to-signal environment remains firmly in place**, as we approach the end of September. Another characteristic that is still prominent is the fact that most of the volatility in nominal rates arises out of real rate changes, rather than market-implied inflation, reflecting the sluggishness of realised inflation figures and, as a result, of inflation expectations.

On the basis of 'domestic' macroeconomic data in the Euro area, one could hardly expect great volatility, given the steadiness of the cyclical information flow. **Output growth remains quite solid** and, indeed, has accelerated. Over the past month, the market was witness to figures such as nominal GDP punching above 3% again (2Q17) and the latest manufacturing PMI rising to the highest level since 2011. At the same time, **inflation acceleration continues to lag behind**, with core HICP still below 1.5%. Furthermore, the same growth vs. inflation dichotomy is also evident in the US.

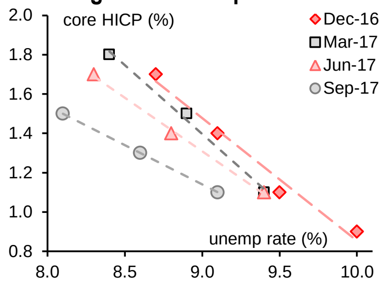
The key driver of volatility in rates markets, therefore, looks set to be the speed and conviction of the expected retreat of various central banks from the 2010s environment of extreme accommodation (aka: financial repression). Not for nothing, over the past several weeks, has the most volatile G7 rates market been the UK (see that section for more details), where **the Bank of England surprised investors** with a much more hawkish tone. Even in the US, the Fed confirmed expectations that it would soon begin balance sheet reduction and implied it will hike in December and, overall by 175 bp by end-2020. In the Euro area, **the ECB remains much more 'patient'**, to use Draghi's favoured expression. No surprise, then, that the EUR 1f1y rate is 6 bp above its early-September lows, while in USD it is more than 25 bp higher and in GBP 35 bp higher.

October ECB meeting likely to see an APP extension

In the current context, therefore, there is a relatively small number of **key events / factors** that should set the tone for EUR rates between now and late October: a) upcoming **US inflation data** (especially the CPI on 13 October); b) whether the recent **Euro FX stabilisation** / depreciation continues; and c) the **ECB meeting** (on 26 October).

While markets can certainly end up pricing in considerably more policy 'normalisation' on the part of the Fed, that can take EUR rates only so far, in isolation from ECB policy action. The September ECB meeting made two things clear: that the inflation pipeline and expectations are still too low for the ECB's liking and that the Governing Council accepts they should communicate how the Asset Purchase Programme (APP) will evolve sooner rather than later. The latest Flash HICP, at 1.5% headline and 1.1% core, does not materially change that. To date, the EUR has stabilised and even corrected slightly in trade-weighted terms. Inflation expectations remain subdued, though the deflations care is well past. Growth is robust, but financial system cohesion arguably still benefits from ECB support. As a result of all these –somewhat conflicting– considerations, we believe that, **on 26 October, the ECB is likely to announce an extension of the APP, rather than a rapid taper / termination**. It is possible that some details will be decided at the December meeting but something like a further six months, at a reduced EUR30/40 bn monthly pace seems to us the most likely outcome.

Chart 37: ECB forecasts imply further flattening of the 'Phillips' curve



Source: ECB, Santander

Bottom line: the twin trends of G7 reflation and monetary policy normalisation point to **higher rates** but the process has been, and will likely continue to unfold, **extremely gradually**, with the Central Banks actively combating any sharp rise in term rates.

In this low rates volatility environment, we think **it still makes sense to be long traded inflation**. Significant economic recovery should underpin a gradual acceleration in core HICP and the slowness of the inflation impulse is not a problem for traded-inflation levels (ILS, BEI), compared with nominal rates, since future inflation accrual is basically neutral vs ILS levels (and positive vs. BEI).

Positioning recommendation:

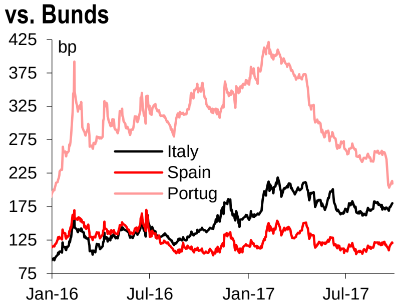
We would stay long Euro area HICP inflation, ideally via a periphery IL bond, since their break-even inflation (BEI) tends to discount lower inflation than IL swaps.

Plenty of value left in periphery EGBs and along the term structure of spreads

In the immediate aftermath of the German election, there was 5-10 bp of widening in periphery Euro area government bond (EGB) spreads over core EGBs. Our view, as stated in previous research, has always been that further EMU integration and institutional 'deepening' was never going to be an easy sell in Germany. Furthermore, it was already widely discussed before the election that Merkel's CDU/CSU would require support from the FDP and/or Greens to reach a majority. There is very little fresh information to trade on, resulting from the elections.

Periphery macro data have remained quite strong in the Iberian economies and continue to improve in Italy, which has been something of a laggard in the 2013-17 Euro area recovery. Q2 nominal GDP growth was over 4% y/y in Portugal and nearly 3½% y/y in Spain. In Italy, it accelerated from less than 1% to 1¾%. Furthermore, since June, economic sentiment survey and PMI readings for Italy have improved markedly, suggesting potential for more catching up. Economic progress is now fully visible in solid employment growth, which is particularly relevant from a fiscal standpoint. All periphery issuers will be entering the FY 2018 Budget season with an improved starting position and EC-compliant figures for 2017-18.

Chart 38: 10y periphery EGB spreads vs. Bunds



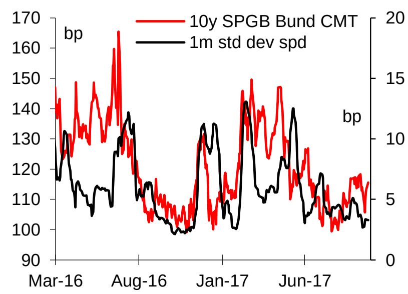
Source: Bloomberg, Santander

Given the supportive macroeconomic/fiscal background, and notwithstanding enduring structural challenges on the demographic and national debt fronts, **the main 'fundamental' source of periphery yield spread volatility we see is the political dimension**. **On that front, Portugal seems well placed**. The government led by PM Costa, of the mainstreams centre-left Socialists, is viewed by investors as having avoided any substantive retreat from the reforms mandated after 2011 or any damaging concessions to its far-left coalition partners, and currently enjoys solid opinion poll readings which have risen steadily.

In Italy, the situation is less clear. On the positive side, the 'caretaker' government headed by PM Gentiloni has been able to discharge day-to-day business and even tackle some controversial issues rather better than had originally been expected. **Gentiloni's personal poll ratings are fairly high**, compared to higher-profile longstanding politicians. Perhaps more importantly, with elections nearing in 2018, the stance of the 5-Star movement and Berlusconi's Forza Italia **on European issues has clearly shifted away from any strong position against the euro**, let alone EU membership. At the same time, there is still uncertainty about which form of electoral law will be used next Spring. Above all, unless there is a much greater shift in voting patterns than polls would indicate, **Italy is facing a repeat of the inconclusive 2013 vote**. Underlying all this is lingering disaffection given that Italy has endured a couple of decades of stagnation in per-capita real GDP. This fuels discontent with established parties and has yet to generate a consensus view of what the solution might be, with untested ideas, such as a dual-currency system or minimum incomes, being seriously bandied about.

In the nearer term, the **greater investor focus**, judging by the flow of questions, is clearly on the **Spain/Catalonia situation**. With both the central government and the regional government engaged in confrontation about the 1 October vote and the details thereof, tensions have mounted. The Catalan issue is a long-standing and complex one and the referendum in 2014 did not, ultimately, lead to any institutional change perceived to affect Spain's fiscal standing. Reflecting that, so far investor behaviour seems to evince interest / monitoring with two-way flows. Such an interpretation is supported by the relatively low volatility of the SPGBs spread over Bund yields.

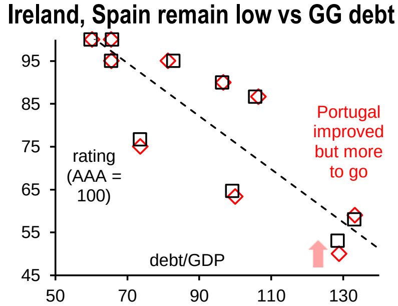
Chart 39: Spain-Germany spread not yet affected much by 1-Oct. tensions



Source: Bloomberg, Santander

Given a better economic underpinning and significant but, overall, manageable political risk, where do periphery spreads stand, in terms of valuation? The cumulative **implied default probability** in the 10y sovereign yield spread over Bunds, adjusting for debt/GDP levels, is **around 25% for Spain and around 27% for Italy** – both very much in the range they have occupied for many months. Such calculations should not be interpreted in overly precise terms, but anything like a 1-in-4 chance of a messy EMU exit / redenomination **seems quite excessive**, considering the lessons of the recent past and the evolution of sovereign liquidity support mechanisms. The equivalent figure **for Portugal**, also in 10y cumulative probability terms, is **close to 33%**. Note that, as recently as this past February, a period of time over which fundamentals have improved but not transformatively so, that implied probability was as high as 51%. As such, we find **periphery spreads still represent good value, *especially in a low-volatility market***.

Chart 40: Ratings of Portugal, Ireland, Spain remain low vs GG debt



Source: Rating agencies, EC, Santander

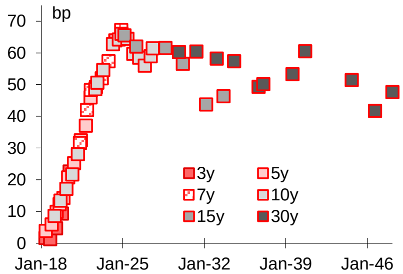
Portugal, of course, has **benefited recently from its first ratings upgrade since 2015**, as S&P upgraded it from BB+ to BBB-. Both Moody's and Fitch have improved the outlook from stable to positive, too, suggesting further upgrades back into 'investment-grade' territory. The **positive ratings momentum is also visible in Spain**, with S&P and Fitch changing the outlook from stable to positive this year. Moody's is likely to follow, if only to conform. Even if actual upgrades are postponed until 2018 (as we had originally supposed), the trend is clearly favourable. It is worth recalling, therefore, that the ratings changes for Italy so far this year have been less benign, with both Fitch and DBRS downgrading them by a notch each. For that trend to invert, one might need to see a consolidation and improvement in Italy's output recovery, though perhaps the recent growth recovery will be sufficient to avert actual downgrades.

<u>Positioning recommendation:</u>

Remain long periphery with overweighting of PGBs and SPGBs and neutral to slightly long BTPs (implying being underweight core EGBs).

Within periphery, the classic Italy-Spain spread has stayed in a relatively tight range of about 20 bp since February (using 10y CMT yields). That positive pick-up reflects lower growth, less clear-cut debt reduction and heavier supply in Italy. We do not expect it to narrow significantly in the near future. Within that broad environment, however, the term structure of BTP-SPGB spreads has been quite uneven and variable. For instance, the difference in steepness between 5y and 10y maturities is quite large and has been increasing (to the detriment of 10y BTPs).

Chart 41: BTP-SPGB interpolated yield spreads term structure (bonds of similar vintage)



Source: Bloomberg, Santander

As stretched as that box spread looks, it looks like trending. Generally we have seen better results from 'nearer' box spreads. Investors seeking to profit from a reduction in the BTP-SPGB steepness might be better served by a trade in the steepest point of the spread term structure: between 2021 and 2022. Conversely, the BTP-SPGB spread slope is inverted between 2025 and 2026. Below we show two such trades.

Trade ideas: SPGB-BTP 2026-2025 and 2022-2021 box trades

1. Buy SPGB Apr-2026 and BTP Jun-2025 vs SPGB Apr-2025 and BTP Jun-2026. Pick-up = 7 bp. Target = 0 bp. Stop-=loss = 9 bp.
2. Buy BTP Apr-2022 and SPGB Jul-2021 vs BTP Jun-2021 and SPGB Apr-2022. Pick-up = 13½ bp. Target = 7 bp. Stop-=loss = 18 bp.

Bund-swap spread stabilisation to gradually turn into tightening

We recently updated out outlook on core EGB swap spreads. As we first suggested in April of this year, Bund-swap spreads have broadly moved sideways in recent months. However, with PSPP buying likely to diminish significantly going forward, that should place pressure on spreads, eventually. Furthermore, the Euribor-Repo financing spread has been stable while the yield curve should steepen slightly; both of which allow for spread tightening. In terms of the on-the-run 10y Bund-Euribor spread, we expect it to head above -40 bp and towards -35 bp by Q1-18.

Euro government bond supply: YTD update

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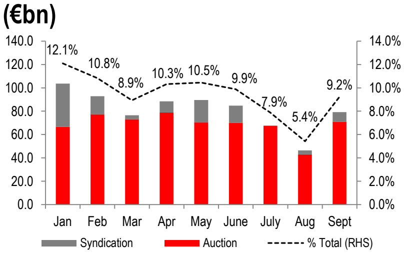
Slight change in the EZ's combined issuance target

In its Quarterly Outlook released on 22 September, the DSTA updated its total borrowing requirements for 2017, lowering the figure thanks to an improvement in the Dutch cash position this year (positive economic and budgetary developments, sale of property, bonds issued above par, termination of swap contracts with positive value, among others). In terms of long-term borrowing requirements, the DSTA said that "the decreasing borrowing requirement primarily translates into lower money market funding. On the capital market some flexibility is possible, but only within the communicated issuing range of € 30-35 bn" (we had an average of €32.5bn) to "a total nominal amount of €31.6bn" for 2017.

Considering the slight change in the Netherlands' expected issuance (down from €32.5bn to €31.6bn), we now estimate a combined Eurozone 2017 borrowing requirement equivalent to €857bn (€858bn previously). As we enter the last quarter of the year, some EUR issuers have already reached their targets for medium-to-long term debt this year. With three full months to go to the end of the year, we expect them to continue issuing debt to take advantage of both improved market conditions and the ECB's outstanding EAPP.

Chart 42: Monthly EZ supply, YtD (€bn)



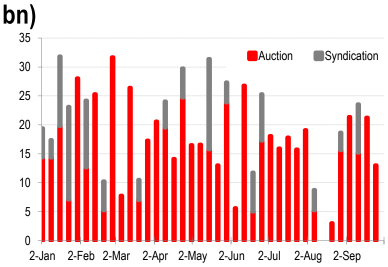
Source: Bloomberg

Towards 90% completion of Euro zone govie issuance

We are seeing a surge in the region's sovereign debt issuance in September, as shown in Chart 42, after the summer break. Through the last week of September, EUR issuers have sold €729bn of bonds via both ordinary auctions (€618bn) and syndicated deals (€111bn), representing an average of 85% of the newly revised 2017 issuance target mentioned above (€857bn).

In terms of YTD completion rates by country, Austria (126%) and Ireland (101%) have already issued more than originally planned for 2017 (taking into account all the syndicated deals). The next in line for the 100% mark is France, which has already covered 94% of its 2017 target, followed by Belgium, at 91%. The remaining EUR issuers, except for Spain (83%) and Italy (82%), are below the 80% mark and are making gradual progress towards completion (see Table 5).

Chart 43: Weekly EZ supply – YtD (€ bn)



Source: Bloomberg

Table 5: Total issued in EZ in 2017, by country (updated as at 29 September)

	GE	FR	NE	AS	SP	BE	PO	IT	IR	FI	TOTAL EZ (€bn)
YtD auctioned issuance	118.0	159.6	23.1	12.0	83.3	17.0	8.7	186.7	6.9	2.5	617.8
YtD syndicated issuance	0.0	14.0	0.0	14.5	27.0	15.0	3.0	24.1	4.2	9.3	111.0
YtD Issuance	118.0	173.6	23.1	26.5	110.3	32.0	11.7	210.8	11.1	11.8	728.8
2017 programme	152.0	185.0	31.6	21.0	133.0	35.0	15.0	257.1	11.0	16.0	856.7
% completion (RHS)	78%	94%	73%	126%	83%	91%	78%	82%	101%	73%	85.1%

Source: Bloomberg , Santander

Table 6: YTD issuance completion vs. historical data

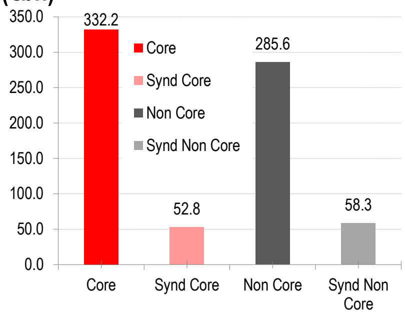
	2012	2013	2014	2015	2016	2017	Aver 12-16
GE	80%	76%	76%	81%	84%	**78%**	79%
FR	78%	80%	80%	81%	83%	**94%**	80%
NE	89%	88%	88%	83%	84%	**73%**	86%
AS	82%	85%	86%	79%	68%	**126%**	80%
SP	69%	79%	80%	84%	81%	**83%**	79%
BE	82%	92%	86%	82%	88%	**91%**	86%
PO	-	100%	87%	87%	90%	**78%**	91%
IT	69%	74%	81%	82%	77%	**82%**	77%
IR	100%	100%	60%	93%	79%	**101%**	86%
FI	89%	89%	89%	96%	85%	**73%**	90%
TOTAL EZ (€)	**76%**	**79%**	**80%**	**82%**	**81%**	**85%**	**80%**

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

In terms of weekly averages, Chart 43 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 the auction arena (not in syndicated deals, which are suffering a drought), taking the Euro zone's weekly average to around €18.8bn (from €18.6bn before August) at the end of September. So far this year, the third week of January (commencing 16 January) was still responsible for the largest volume of supply, with €32bn placed, including syndications, whereas the week commencing 14 August saw no activity at all.

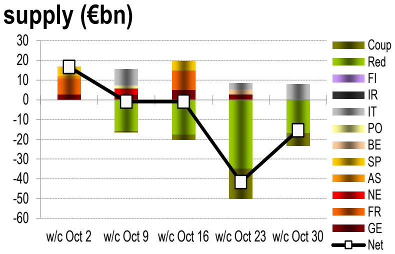
As shown in Table 6, 2017 is proving another record year, with a number of EUR issuers taking their average completion rates to fresh highs for this historical data.

Chart 44: YTD issuance by category (€bn)



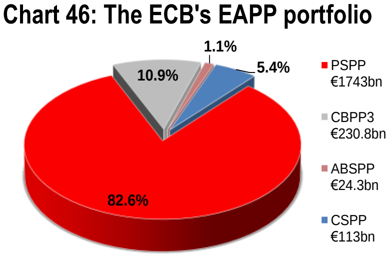
Source: Bloomberg

Chart 45: Expected net EUR bond supply (€bn)



Source: Bloomberg

Chart 46: The ECB's EAPP portfolio



Source: ECB, Bloomberg,Santander

stage of the year. Austria (126%), Ireland (101%) France (94%) and Italy (82%) have set new records in terms of bond issuance completion rates in at least the last five years. For the Euro zone as a whole (85%), this average completion rate is also well above the levels seen at this stage of the previous five years (80% for the 2012-2016 period) thanks to unprecedented front-loading due to the improved macroeconomic environment, with the help of the ECB's extraordinary monetary policy measures.

Core issuers ahead of periphery counterparts

Core issuers continue to outpace the Euro zone periphery as we progress towards the end of the year. Core issuance accounts for 53% (vs. 50.3% back in June) of the total, the equivalent of €385bn, while periphery supply makes up the remaining 47% (vs. 49.7% in June), or €344bn. The core countries have auctioned around €332bn, versus the periphery's €286bn, so far in 2017 (Chart 44), while the non-cores have placed 1.11x more via syndicated deals than their core counterparts (€58bn vs. c.€53bn).

France's and the Netherlands first estimate of next year's funding needs

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

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

Supply dynamics: Negative net EUR supply next month

In October, we expect more than €65bn in new auctions (not including syndicated deals). We expect France and Italy to issue more than €18bn each, Spain in the range of €8-9bn and Belgium is scheduled to place an estimated €2-3bn of debt in the week commencing 23 October. Germany has already announced that will issue €19bn. Also, the Netherlands will be launching a new 7y DSL (Jan'24) via DDA for up to €7bn on 11 October. Portugal, Ireland and Finland could also issue debt this coming month. However, scheduled redemptions of more than €85bn and coupon payments of €25bn (including Spain's €16.8bn in bond redemptions and €6.6bn in coupon payments on 31 October) will be enough to offset October's supply. Consequently, net EUR issuance will be negative by around €42bn for the next four to five weeks (Chart 45).

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 22 September, shows the ECB has accumulated more than €2.1trn in assets since the programme began last year. According to the latest report, the PSPP portfolio totals €1.74trn in Euro govies and supras, accounting for 83% of the ECB's monetary policy portfolio, while CPBB3 holdings now amount to €231bn, which represents 11% of the portfolio. The CSPP has reached

€113bn, and the ABSPP now stands at €24.3bn, representing 5% and 1% of the total, respectively.

UK Monetary Policy Outlook: De-constructing the rate hike case

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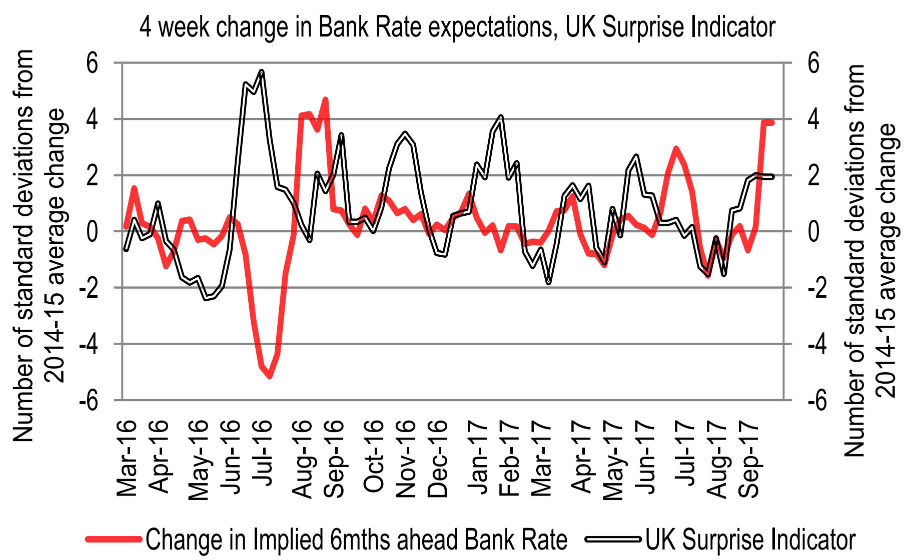
- **Shift in MPC rhetoric leads us to expect a November rate hike…**
- **…but we still regard the case for higher rates as unconvincing, and expect a single rate hike (0.25%-pt), rather than a tightening cycle**
- **We see concerns around the economy's supply potential, highlighted by recent labour data, as motivating the shift in rhetoric**

Shift in MPC rhetoric signals a November rate hike…

We have updated our expectations for UK monetary policy through to end-2018, and focused upon identifying the likely motivating factors behind the marked shift in the Bank of England Monetary Policy Committee's (MPC) policy rhetoric, with an imminent increase in Bank Rate now having been signalled (see UK monetary policy outlook note). Following this change of language at the September MPC meeting –focused, of course, upon the admission that a majority of policymakers are likely to support a tightening of policy in the coming months, should the current trend of data releases continue– we now expect a 0.25% increase in Bank Rate to be sanctioned on 3 November. However, we remain sceptical of the economic case for such a move, and our expectation of a November rate hike is based largely upon the potential loss of credibility that could be incurred by the MPC, should the Committee not raise rates following this pronounced shift in rhetoric.

Rather than anticipating a series of rate hikes developing over the coming months, we would expect a November increase to prove a one-off move ('one and done'), and see Bank Rate remaining at 0.5% through to end-2018. We also expect this anticipated tightening of monetary policy to be effectively confined to Bank Rate, with the level of sovereign debt purchases within the Asset Purchase Facility holding at GBP435bn, and the corporate bond purchase scheme also seen remaining at GB10bn (albeit with a lower level of conviction with regard to the corporate bond scheme).

Chart 47: The recent shift in market rate expectations is almost as severe as that which followed the EU referendum result



Source: Bloomberg, ONS, Santander
Note: Chart shows the 4-week change in the implied change in UK Bank Rate, six months ahead, and our UK surprise indicator. Data are expressed in terms of the number of standard deviations from the average change recorded in each series between January 2014 and December 2015.

…but we believe the move relates to a change in reaction function, rather than improving data releases…

Given that recent UK data releases have only marginally beaten what we would regard as modest expectations –rather than significantly surpassing them– we still find the timing of the MPC's shift in tone to be surprising. Based on both our own reading of recent data releases and the near-term outlook, we believe that the case for higher rates remains unconvincing. We consequently attribute the shift in MPC rhetoric to a change within the Committee's reaction function. As such, we believe that exploring the potential causes for this apparent shift in the MPC's reaction function –which we see largely relating to concerns around the UK economy's supply-side performance, and the impact of Brexit upon this.

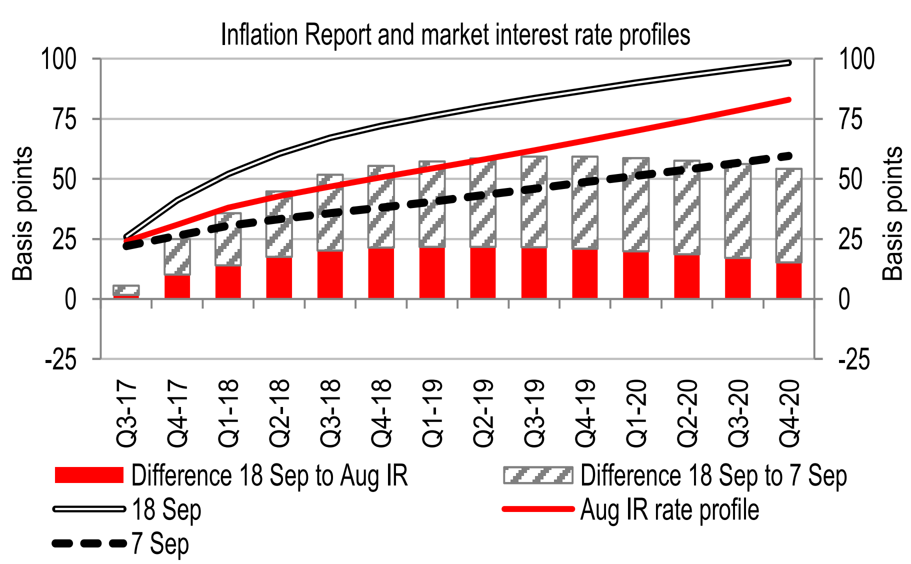
Supply-side concerns seen as the primary motivating factor

1) August message was missed, and required reinforcement:

Our first potential explanation actually relates to the August MPC meeting, rather than developments this month, and the possibility that the Committee believed that the more hawkish messages contained in that month's Inflation Report were fundamentally misinterpreted by the market, necessitating the more direct guidance seen this month. Certainly, in the aftermath of the August Inflation Report release, we questioned the dovish market reaction, given that the Committee's updated CPI projection clearly signalled the need for a move higher, and not lower, in the market-implied path of Bank Rate. The further, projected acceleration of inflation during the final year of the Committee's forecast period –repeating the view from the May Inflation Report– was, in our view, an unambiguously hawkish development.

We believe this guidance factor likely explains a part of the motivation for the recent shift in the MPC's tone and, as illustrated in Chart 48, the market rate profile has moved well above that used to condition the August Inflation Report projections. Indeed, given the scale of the movement shown in Chart 48, we feel that the degree of understanding and perceived market visibility around the MPC's reaction function could suffer considerably should the Committee not follow its recent words with action, and swiftly implement the first rate hike for over a decade.

Chart 48: The profile of market rates has now moved well above the level used to condition the August Inflation Report



Source: Bank of England, Santander.

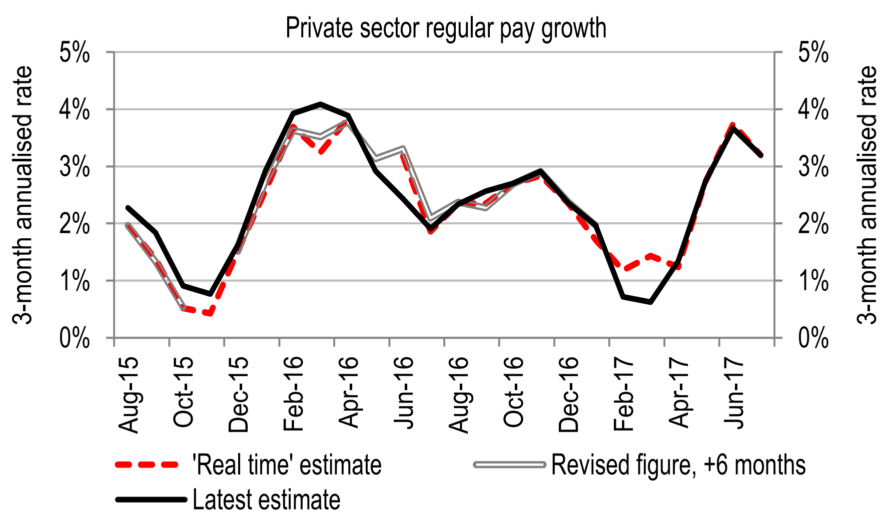
2) Recent labour market releases may have aggravated supply-side concerns:

A more fundamental explanation, we believe, relates to possibility that growing concerns around the UK economy's supply potential –and the impact of the Brexit process upon this– may have decisively tipped the balance of opinion across the Committee towards a more hawkish direction.

In our view, an increased focus on supply-side developments was certainly noticeable at the August Inflation Report press conference. Following September's labour market data, which suggested a further erosion of spare capacity across the economy, Governor Carney, in a speech stressed that the MPC's willingness to tolerate above-target inflation is declining, with some tightening of policy likely required if current trends continue.

In terms of the bare numbers, the further fall in the headline jobless rate to just 4.3% has challenged the key August Inflation Report judgement that some degree of slack was likely to remain across the economy throughout the forecast period (to Q3-20). Nevertheless, we still question whether the decline in the headline rate of unemployment to 4.3%, and the apparent prospect of a further small fall in the coming months, should be viewed as decisive to the medium-term outlook for price stability. Indeed, while the minutes to this month's MPC meeting referenced rising wage growth (to c3% ex-bonuses), but as Chart 49 shows, when expressed on a three-month annualised basis, we note that similar messages were presented by such an analysis in spring 2016, but that the underlying trend of pay growth ultimately maintained its weakening bias. Thus, we believe presenting the data over this short, annualised period risks offering a misleading view of wage growth.

Chart 49: Wage growth has proved volatile on a 3-mth annualised basis, but the underlying trend appears flat around the 2.5% per annum rate



Source: ONS, Thomson Reuters Datastream, Santander.
Note: "Real time" estimates relates to the growth rate reported for the latest period covered by each monthly release.

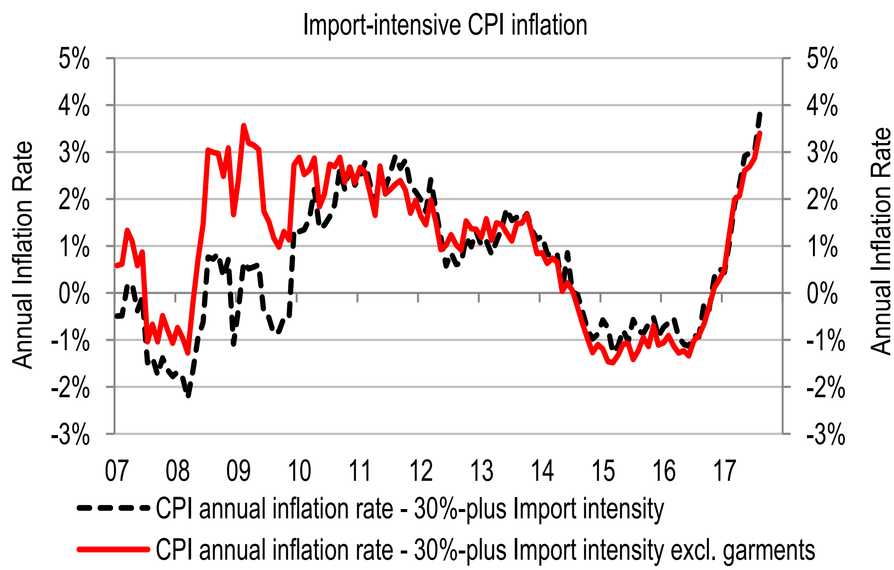
3) The MPC's interpretation of the CPI data may suggest a more prolonged overshoot:

Rather than the economic outlook more generally, the change in the Committee's tone could, in theory, simply reflect the expectation of a larger overshoot of the 2% CPI target, which –even without a change to the MPC's reaction function– would increase the pressure for tighter policy. In the minutes to the September MPC meeting, some prominence was attached to the increased likelihood of CPI inflation breaching the 3% level, as well as the August Inflation Report's estimate of Q3-17 CPI (2.68% average).

However, we question whether the August CPI data represented a genuine upside surprise, or –as we argue instead– evidence of a faster pass-through of imported price pressures, in turn preparing the ground for a sharper deceleration of inflation through 2018. Chart 50 illustrates both the calculated annual inflation of those goods and services within the CPI with an estimated direct import intensity of 30% or more, adjusted for the clothing price distortion (see note for more detail). We believe that a very different perspective of the duration and speed of this pass-through effect is provided, in our view questioning the MPC's assumption that a further, substantial increase in external price pressures is yet to be reflected within the CPI data.

Greater clarity around this issue will not be available until early-2018, perhaps suggesting that a 'window of opportunity' exists to implement a rate hike around the time of the November MPC meeting, before the inflation data offers a more dovish view as the February 2018 meeting approaches.

Chart 50: The rise in UK inflation continues to be driven by goods prices, not services



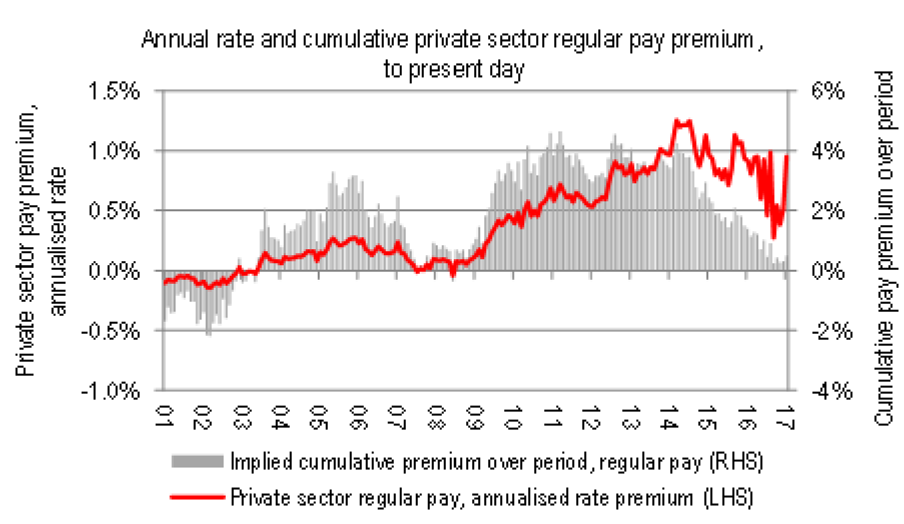
Source: ONS, Thomson Reuters Datastream, Santander.
Note: Chart shows the calculated annual inflation rate of the CPI components with an estimated direct import intensity of 30% or more, and the same series, excluding the garment category (COICOP code 03.1.2).

4) Looser fiscal policy may require less of a monetary offset:

In our June 2017 publication, 'Austerity and the election: New thinking, or just wishful thinking?', we outlined why do not expect a material loosening of UK fiscal policy to occur in the near term, despite the inconclusive outcome of the recent General Election. In that note, we highlighted the limited room for fiscal manoeuvre relative to the key fiscal mandate. Nevertheless, with the upcoming Budget now confirmed for 22 November, speculation of a loosening of fiscal policy has proved persistent, particularly following the government's decision to lift the 1% pay growth ceiling for certain areas of the public sector.

However, although a major acceleration of public sector pay growth –perhaps in order to account for the recent underperformance relative to average earnings growth across the private sector (as highlighted in Chart 51)– would clearly be of key significance to the monetary policy outlook, we believe such a prospect remains highly unlikely under the current government.

Chart 51: The case for a 'catch-up' in public sector pay rests heavily on the start-point of any analysis



Source: ONS, Thomson Reuters Datastream, Santander.
Note: Chart shows difference between private and public sector (excluding financial institutions) regular, ex-bonus pay growth, between period shown in chart and the present day. Data expressed in annualised and cumulative terms. A positive SG implies stronger private sector pay relative to the public sector.

5) New members may have shifted the centre-ground:

One competing, but less fundamental, explanation for the MPC's change of rhetoric relates to the possibility that the two recent appointments to the Committee –Sir Dave Ramsden as Deputy Governor for Markets and Banking, and external member Silvana Tenreyro – may also have tipped the centre ground of opinion across the group. With both of the new arrivals yet to speak publically on monetary policy, this potential explanation is, of course, purely speculative.

6) 'One and done' may have sealed the majority move:

A final possible explanation we see for the more hawkish MPC rhetoric relates to a desire to simply reverse the interest rate cut (but not QE extension) implemented in August 2016 –and move Bank Rate back to 0.5%– rather than any desire to initiate a full-blown hiking cycle. A 'one and done' scenario may, in theory, make for a compromise across the Committee between the more hawkish members and those more concerned by how the structural challenges facing the UK economy might influence demand during the Article 50 process and beyond.

Supply-side fears and CPI view suggest action, but not a cycle

Overall, concerns around the economy's supply potential –as evidenced by the detail of the recent unemployment data– represent the most credible explanation for the MPC's shift in rhetoric, with a November rate hike now anticipated. We also believe both the dovish market reaction to the August Inflation Report and the recent personnel changes across the MPC also contributed to a more hawkish stance. However, with the prospect of a material shift in fiscal policy likely exaggerated, in our view, and the detail of the recent CPI data –if not the headline numbers– highlighting the scope for inflation to decelerate through 2018, we expect the MPC's newfound activism to be limited to a single rate hike in November 2017 (to 0.5%).

UK Rates Strategy: Curve to have more work to do after a hike

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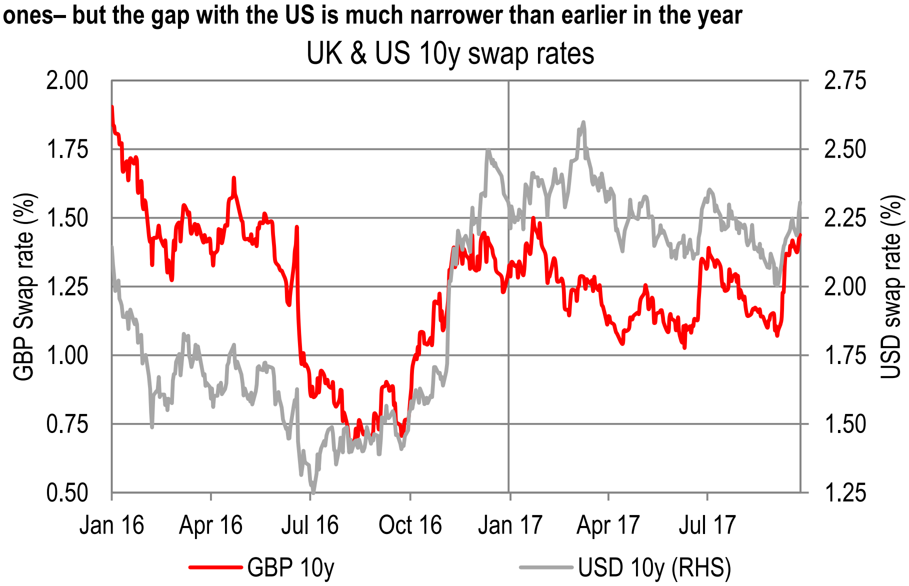
- **Outright UK rates have increased sharply and returned to pre-EU-referendum levels thanks to the BoE's hawkish turn**
- **The slopes of the rate curves have remained much more stable and should catch up if a hiking cycle begins, such as 1y1y/3y1y**
- **Even this limited steepening means 5y has led the way and looks 'cheap' by recent standards, but we see this as more likely to continue than reverse**
- **The narrowing of the UK's FRA-OIS basis over the last year is also unlikely to reverse, as we explored in a recent article**

Higher short GBP rates have left longer tenors in their wake

We review the recent changes to the BoE monetary policy outlook in the UK Economics section, above. Here, we will consider its impact on the swap and gilt term structures, and whether the curves have further to adjust even if short-rate views stay roughly where they are, and the MPC act as expected on 2 November.

Term rates have certainly joined in the MPC-inspired sell-off, which has taken the UK-US 10y rate differential to its tightest since last November, when the 'Trump reflation' narrative was still gathering steam in the market (Chart 52). The renewed prospect of corporate tax reform in the US has given that force a new lease of life in recent days, although UK rates have shown a limited reaction thanks to their 'head start' from the sell-off earlier in the month.

Chart 52: Long-term UK rates are close to this year's highs –but not yet setting new ones– but the gap with the US is much narrower than earlier in the year



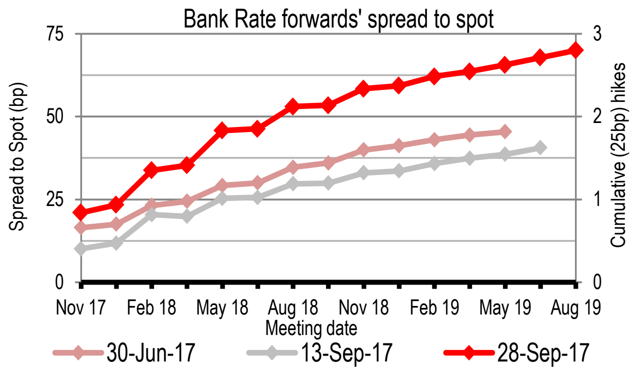
Source: Bloomberg, Santander.

Weekly moves in 10y GBP and USD rates exhibited a 89% correlation in the year prior to the EU referendum, and this has been only modestly lower over the last year, at 75%, despite the increasing attention being paid to country-specific developments, such as elections and trade/Brexit negotiations over that time. These statistics underline a recurring argument behind our UK rates outlook: rising USD and –increasingly over 2018, according to our forecasts– EUR rates are likely to set the trend for those in the UK.

With monetary policy shifting (slowly) towards a tighter stance in the Eurozone, US and UK, we expect the recent bearish mood to continue and to push rates yet higher. We think this is likely to be more of a drift for gilts than the two sharp jumps seen after recent MPC meetings, and almost certainly not in a very straight line.

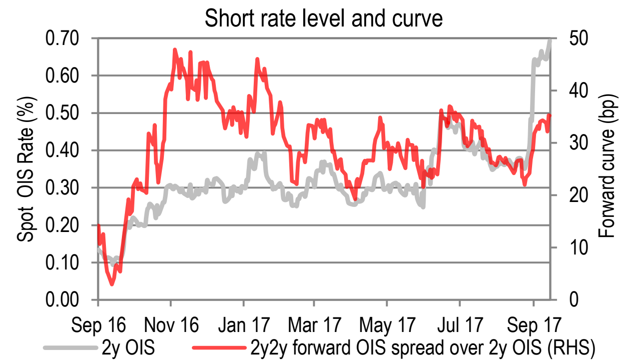
In particular, we would expect further steepening of short UK rates if the MPC does hike next month. The market is currently pricing a very short, sharp tightening cycle of about three hikes by the MPC in the next two years (Chart 53). The conviction and extent of the implied hikes is much stronger than at the last peak in rates, after the MPC communications in June. But longer-term rates have shown a more muted reaction than last time, steepening less than they previously managed in the face of smaller re-pricings in short rates (Chart 54).

Chart 53: A UK hiking cycle is now priced much more aggressively than the previous peak, after June's MPC jolt…



Source: Bloomberg, ICAP, Santander.

Chart 54: …but the curve has remained remarkably flat beyond the first two years, implying a very sharp but truncated 'cycle'



Source: Bloomberg, Santander.

We suggested a 1y1/3y1y steepener ahead of the last MPC meeting, which we still recommend due to the surprising flatness of the curve. Our initial recommendation was in anticipation of a dovish, rather than more hawkish, surprise, but was chosen to also benefit even if a hiking cycle was to arise. It is currently about 2bp in the money, and we see as much as 10bp more to play for if the MPC does deliver a hike.

We are fairly indifferent to the exact instruments and tenors used to express a front-end steepener view. The curve has failed to steepen both in the very short tenors of our recommendation, or in the wider sectors such as 2s5s or 2s10s.

Trade expressions aside, we strongly prefer OIS rates for time series analysis, especially towards the short end. We find them to be a more fundamentally accurate measure of base rate expectations, and the considerable narrowing of the FRA-OIS basis this year distorts Libor-based comparisons over time (Chart 55).

We explore several factors behind this, and the BoE's Sterling Monetary Framework more generally, in a recent article on Reserves averaging and Libor in the UK. We conclude that the main factors behind the narrowing are unlikely to reverse (increased reserves, low financial system credit risk and the gradual transition to Sonia as the UK's main reference rate), so the basis should stay tight going forward.

Further out, what steepening has been seen peters out beyond the 5y point, and 5s10s has flattened sharply in the sell-off to leave 2s10s little changed (Chart 56). At first glance this suggests a dislocation to fade, but we would caution against this.

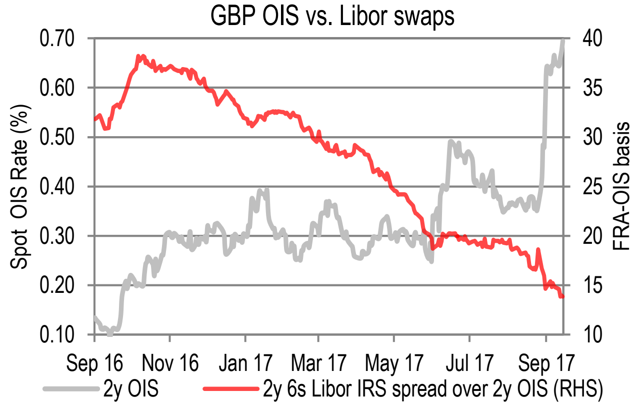
Although the positive correlation between short (2s5s) and medium (5s10s) rate slopes has been in place for a long time, their values are not so out of line with historical conditions. The 2s5s10s fly has been negative since the start of 2016, and is now almost back into positive territory – as was the case during

2014 and 2015, when rate hikes were last seen as a likely proposition.

We would expect 5y to continue leading the way once hikes begin, and see a scenario of 2s5s10s becoming positive as more likely than a return to the lows. This fits the transition from expecting a hiking cycle 'one day' in the distance, after the immediate uncertainties and challenges of Brexit are resolved, to the MPC's apparent determination to bring this forward into the immediate future, and the reduced need for a future hiking this implies.

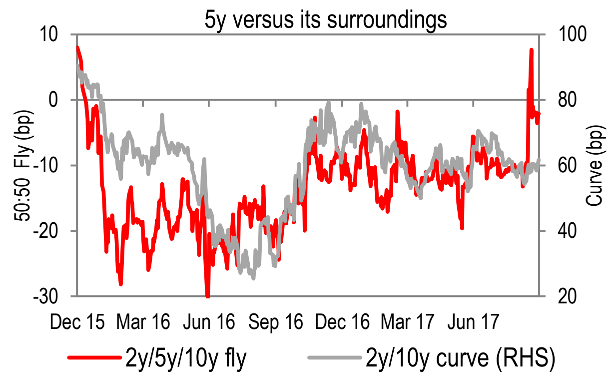
Domestic economic and political news can cause short-term deviations from the bearish international backdrop, but the UK's particularly high degree of global financial integration should limit how far they can run. We expect such a spell of divergence at some point next year, if/when the UK economy slows from some combination of a tighter monetary policy stance and challenges on the road to Brexit. We expect such a 'wobble' to reverse most of the further sell-off we expect over the next few months, but for this to prove temporary, before upward momentum in UK rates reasserts itself by the end of the yearx.

Chart 55: The Libor-Sonia basis has been falling steadily for almost a year, regardless of gyrations in outright rates



Source: Bloomberg, Santander.

Chart 56: The 2s5s and 5s10s curves longstanding correlation abruptly reversed in the latest sell-off, so 5y cheapened up sharply relative to a 2s10s curve which barely moved



Source: Bloomberg, Santander.

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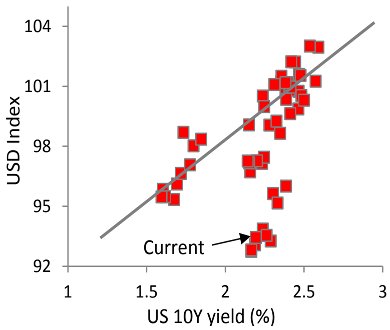
Chart 57: The USD still looks oversold post the FOMC…



Weekly data over the last year
Source: Bloomberg, Santander

USD – The Fed to the rescue

We expect the USD to remain firm over the coming months and to reverse some of its recent losses against its developed-market peers. Following the September FOMC, a December Fed hike now seems more likely. The geo-political tensions, that had weighed on the USD, appear to have diminished somewhat. The US economy remains robust and is still forecast to outperform its peers.

The September FOMC made no change to US interest rates, with the Fed Funds target rate remaining in a 1-1.25% range. However, the Fed confirmed that it will act to reduce its balance sheet, by phasing out reinvesting the payments on its asset purchases (QE). A smaller Fed balance sheet should shrink the supply of USD in the financial system, boosting the currency's value.

In addition, the Fed also signalled that a December 2017 rate hike is possible. One of the reasons for the USD weakness over the last few months was the market's view that another US rate hike this year had become unlikely as US inflation eased.

At the start of September, the probability of a US rate hike was calculated as being 34%. Following the September FOMC, this rose to 60%.

Moreover, the plan to slim the balance sheet seems unlikely to slow the pace of rate hikes over coming years. The September 'dot chart', indicating FOMC members expectations for monetary policy, was not significantly revised.

The median expectation for rates in 2017 and 2018, was unchanged, at 1.375% and 2.125%, respectively, although the 2019 median was reduced by just 25bp, to 2.6875%.

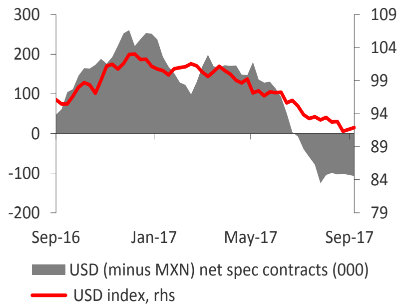
Hence, even though the core CPI forecast was cut to 1.5% at the end of 2017, down from 1.7%, and is not expected to return to target until 2019, the Fed remains on course to hike rates over the coming years.

Table 7: G10 FX forecasts

	Q4 17	Q1 18	Q2 18	Q3 18	Q4 18	Q1 19
EUR-USD	1.14	1.15	1.17	1.18	1.20	1.22
GBP-USD	1.32	1.3	1.28	1.26	1.25	1.25
GBP-EUR	1.16	1.13	1.09	1.07	1.04	1.02
EUR-GBP	0.86	0.88	0.91	0.94	0.96	0.98
USD-JPY	114	116	118	119	120	122
EUR-JPY	130	133	138	140	144	149
EUR-CHF	1.12	1.14	1.14	1.16	1.20	1.22
USD-CHF	0.98	0.99	0.97	0.98	1.00	1.00
EUR-SEK	9.5	9.4	9.3	9.1	9.0	8.8
EUR-NOK	9.0	8.9	8.8	8.8	8.6	8.5
USD-CAD	1.25	1.25	1.24	1.24	1.22	1.22
AUD-USD	0.73	0.72	0.73	0.73	0.75	0.76
NZD-USD	0.66	0.67	0.68	0.69	0.70	0.72

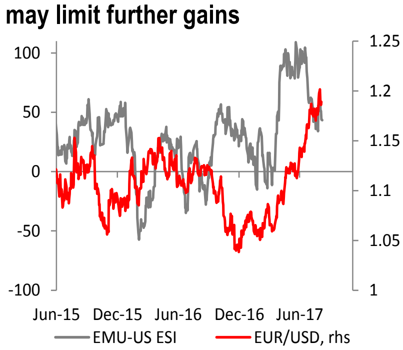
Source: Bloomberg, Santander

Chart 58: …so FX market may be caught short



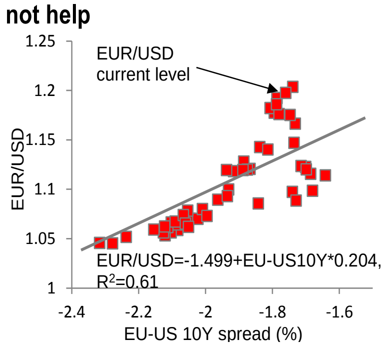
Source: CFTC, Bloomberg, Santander

Chart 59: Fundamentals are still EUR supportive, but less upside surprises may limit further gains



Source: Bloomberg, Santander

Chart 60: EUR/USD looking expensive given yield spreads and possible G10 monetary policy changes may also not help



Data covering the last year

Source: Bloomberg, Santander

Admittedly, a less accommodative stance from the ECB, BoC, BoE, etc. will temper a USD rally, but the Fed outlook should now be more USD supportive and no longer a reason to sell the currency. Indeed, we think it has scope to rally further as we still see the USD index as undervalued given current US 10Y yields.

The USD may also find support from a reduction in geo-political tensions. Concerns over North Korea and the US administration's ability to push through policy changes will remain, but may hold less sway over the markets through to the end of the year.

Hence, the market should prove willing to unwind the short USD positions built up throughout 2017 so far, particularly since July 2017. The IMM non-commercial position data show that USD sentiment has been in free-fall for most of the year.

The net composite USD position, excluding the MXN, turned negative in July. We have indicated in the past that we viewed this USD bearishness as too excessive and, now, the FOMC has provided the FX market with a clear signal to reverse it.

EUR – Take a breather

Overall, we are still positive about the EUR into 2018, but continue to feel that some of the recent gains may have been overdone. Further, whilst we expect the ECB to adopt a less accommodative policy in 2018, its stance is set to remain looser than other central banks', implying that the EUR will not be the clean winner from monetary policy changes.

EUR/USD remains strong, but the uptrend that started in May, after the French election, looks vulnerable. The pair fell below its 55 -day moving average on 28 September, the first time that it had breached this gauge since April.

That said, the Eurozone's fundamental data remain supportive, suggesting any sell-off should be mild. The Eurozone economic surprise index (ESI) remains positive, albeit at a lower level than in May. However, the fact that data surprises appear less EUR-positive may be explained by the fact that the market was too pessimistic at the start of the year.

The ending of this economic pessimism also justifies the stronger EUR. However, much of the region's positive economic news should already be priced in and it may require even better European data, or poor US data, to allow the pair to appreciate further.

We expect the Eurozone to grow 2% in both 2017 and 2018. But we forecast stronger US growth, at 2.2% in 2017 and 2.8% in 2018. Hence, fundamentals should be sufficient to provide EUR support, but may not be strong enough to produce additional gains.

Diminishing European political risks have removed a key reason to short the EUR. The German Federal Election, on 24 September, returned Merkel as Chancellor. There is some uncertainty as to the form her new government will take, but wrangling over a coalition is not expected to be a major negative for the EUR, but may temper further gains.

The ECB made no change to its policy in September. Recent comments from officials still suggest that the Bank's asset purchase programme will be tapered in H1-18, with further details expected at the 26 October ECB meeting. We think the ECB will extend its asset purchases in to H1-18, but at a lower rate, perhaps EUR30/40bn per month (rather than EUR60bn) and maintain an option to extend the programme in to H2-18 if needed.

The EUR may benefit from a 'taper' bid closer to the October meeting, but we suspect the announcement may not prove sufficiently 'hawkish' enough to encourage a market that is already long the EUR to add to those positions.

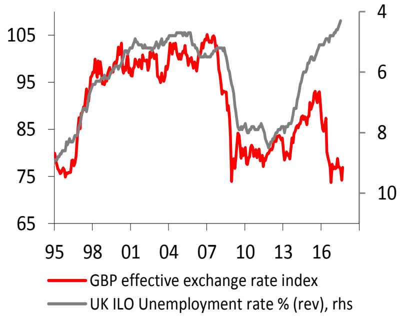
Indeed, given that we still expect the Fed to hike rates by year-end and to move to reduce its balance sheet, that the BoC hiked rates in September and that the BoE is sounding hawkish, the EUR could yet falter against the USD, CAD and GBP amid changes to monetary policies.

Note, as we indicated in EUR/USD yielding too much ahead of the ECB, published 5 September, it can be argued that EUR/USD has already appreciated too far, given the current developments in EUR-USD ten-year spreads.

GBP – Up, as focus on rates rather than Brexit

We have revised up our near-term Sterling view to reflect the recent jump in spot levels amid signs that the BoE is preparing to hike interest rates over the coming months. However, we still favour a downside bias for 2018, given that the economy still appears vulnerable, inflation is expected to ease and Brexit concerns do not seem likely to disappear.

Chart 61: Pound still cheap given fundamentals…



Source: Bloomberg, Santander

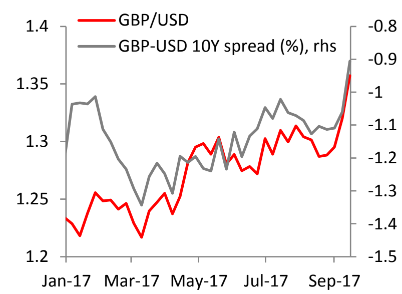
The BoE's Monetary Policy Committee made no change to policy at its September meeting, but its tone was viewed as much more hawkish than expected. In particular, it was noted that a majority now considers that "some withdrawal of monetary stimulus was likely to be appropriate over the coming months".

The market is now pricing in a 70% chance of a rate hike at the BoE's November meeting, compared to a 22% chance at the start of September. The correlation between GBP/G10 crosses and their respective two- and ten-year spreads has been very strong since the start of the year.

Hence, the change in rate expectations justifies the rise in Sterling. Moreover, fast money accounts went into the meeting still holding a large net short GBP/USD position, and unwinding even some of this should allow the Pound to sustain higher levels for a while.

In addition, as we previously highlighted, the sell-off in the Pound, since the June referendum, did imply that the currency was too weak in terms of traditional fundamental indicators, with Sterling sold aggressively amid market fears as to what Brexit would imply for the economy and the GBP.

Chart 62: ...but gaining on interest rate outlook



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

The change in BoE rhetoric is sufficient for us to adopt a less negative view on the Pound, but whether recent gains can be added to will depend not only on whether the Bank does hike soon, but whether this is part of a tightening cycle, which would allow the market to bid the currency higher and smother its concerns about Brexit.

In this regard, recall that whilst UK inflation is high (2.9% YoY in August), we expect it to start to decline from October. Further, whilst unemployment is low (4.3%), wage growth remains muted. Hence, inflation pressures may provide less support to rate expectations, and the GBP, from late 2017.

In addition, UK economic data, aside from the CPI, have continued to offer Sterling little by way of sustained support. The UK economy grew by 0.3% QoQ in Q2-17, compared with 0.6% for both the Euro zone and the US. Admittedly, the decline in the Pound since June 2016 should have already priced in poor data, but it should remain vulnerable to data disappointments.

Further, the market may be unwise to forget about Brexit. One rate hike would merely imply a removal of the 'emergency' cut made following the referendum in June 2016. Plus, the BoE believes that inflation is high because the Pound is weak, and the Pound is weak because of the market's concerns about the Brexit impact.

The UK-EU negotiations do not appear to be going as well as expected. For now, the market is ignoring that, but if they do not improve over the coming months, we suspect that a reinvigorated Sterling will merely be viewed as a better level at which to sell.

Euro interest rate forecasts

Government Bond yield Forecasts

Bunds	Current	4Q17	1Q18	2Q18	3Q18	4Q18
ECB Depo	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40
3m	-0.67	-0.70	-0.70	-0.70	-0.60	-0.55
2y	-0.70	-0.60	-0.45	-0.25	-0.10	0.05
5y	-0.28	-0.25	-0.05	0.15	0.35	0.55
10y	0.45	0.55	0.75	0.95	1.15	1.25
30y	1.29	1.35	1.55	1.70	1.85	1.90

Swap rate forecasts

€ swaps	Current	4Q17	1Q18	2Q18	3Q18	4Q18
ECB Depo	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40
3m	-0.33	-0.33	-0.33	-0.28	-0.23	-0.13
2y	-0.17	-0.05	0.05	0.15	0.25	0.40
5y	0.24	0.30	0.45	0.60	0.75	0.90
10y	0.90	1.00	1.15	1.35	1.50	1.60
30y	1.61	1.70	1.85	2.00	2.10	2.15

US interest rate forecasts

Government Bond yield Forecasts

USTs	Current	4Q17	1Q18	2Q18	3Q18	4Q18
FOMC (mid)	1.125	1.375	1.375	1.625	1.875	2.125
3m	1.04	1.20	1.35	1.60	1.90	2.15
2y	1.45	1.65	1.90	2.15	2.35	2.50
5y	1.89	2.00	2.20	2.45	2.70	2.90
10y	2.30	2.35	2.55	2.80	3.05	3.25
30y	2.86	2.90	3.00	3.15	3.30	3.45

Swap rate forecasts

$ swaps	Current	4Q17	1Q18	2Q18	3Q18	4Q18
FOMC (mid)	1.125	1.375	1.375	1.625	1.875	2.125
3m	1.33	1.45	1.60	1.85	2.15	2.40
2y	1.71	1.90	2.15	2.40	2.60	2.75
5y	1.96	2.10	2.30	2.55	2.80	3.00
10y	2.26	2.30	2.50	2.75	3.00	3.20
30y	2.53	2.60	2.70	2.90	3.05	3.20

UK Interest rate forecasts

Government Bond yield Forecasts

Gilts	Current	4Q17	1Q18	2Q18	3Q18	4Q18
MPC	0.25	0.50	0.50	0.50	0.50	0.50
3m	0.33	0.45	0.40	0.37	0.37	0.42
2y	0.44	0.60	0.70	0.50	0.35	0.40
5y	0.78	1.10	1.30	0.90	0.80	0.90
10y	1.36	1.50	1.70	1.40	1.30	1.50
30y	1.92	2.20	2.50	2.10	1.80	2.00

Swap rate forecasts

£ swaps	Current	4Q17	1Q18	2Q18	3Q18	4Q18
MPC	0.25	0.50	0.50	0.50	0.50	0.50
3m	0.34	0.55	0.55	0.52	0.52	0.52
2y	0.81	0.90	1.10	0.80	0.70	0.80
5y	1.10	1.40	1.55	1.15	1.15	1.20
10y	1.41	1.55	1.70	1.50	1.40	1.55
30y	1.64	1.90	2.15	1.70	1.40	1.60

FX forecasts

	Current	4Q17	1Q18	2Q18	3Q18	4Q18
EUR-USD	1.183	1.14	1.15	1.17	1.18	1.20
EUR-GBP	0.883	0.86	0.88	0.91	0.94	0.96
GBP-USD	1.200	1.32	1.30	1.28	1.26	1.25
USD-JPY	112.3	114	116.0	118.0	119	120
EUR-JPY	132.8	130	133.4	138.1	140	144

	Current	4Q17	1Q18	2Q18	3Q18	4Q18
NZD-USD	0.724	0.66	0.67	0.68	0.69	0.70
USD-CAD	1.247	1.25	1.25	1.24	1.24	1.22
AUD-USD	0.785	0.73	0.72	0.73	0.73	0.75
EUR-CHF	1.146	1.12	1.14	1.14	1.16	1.20
EUR-SEK	9.63	9.5	9.40	9.30	9.1	9.0
EUR-NOK	9.41	9.0	8.90	8.80	8.8	8.6

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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.

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