27 July 2018, 12:45 CET

Interest & Exchange

Trade Tensions and Curve Inversions

Global Strategy: While the economic cycle continues registering record longevity, trade tensions and a gradual removal of monetary accommodation cast doubts regarding the timing and abruptness of the next deceleration. The Fed will probably ignore recent pressures and continue gradually raising rates, but they will probably stop earlier than they currently envisage. With the front end being driven by domestic factors but the global hunt for yield keeping long-end rates from rising faster, the US curve is likely to invert, but a recession does not have to necessarily take place in the aftermath of the upcoming curve inversion.

US Macro: The US labour market is tightening very fast. Job creation remains strong, while working population growth rates are limited by the still low labour participation ratios. The unemployment rate could surprise on the downside in 2019. The goods-producing sector leads the adjustment, while the services sector is still lagging. We expect this pressure in the labour market to translate into rising earnings per hour in coming quarters.

US Rates: After several weeks of trading within very narrow ranges, medium- and long-term US rates have finally come back to life. While moving in the right direction, we still do not see the recent spike in US rates as the beginning of an imminent bearish trend. We maintain our approach of being short through carry-efficient alternatives and recommend taking advantage of the dislocations created by this fast market move by paying the belly in 2s5s30s in USD swaps.

EUR Macro: The protectionist measures announced so far by the US should have a limited impact on Eurozone exports, focusing largely on those from Germany and on the autos and machinery sectors. However, we could see negative “second round effects” consisting of a loss of business confidence that would adversely affect investments and growth in the coming months.

EUR Rates: The ECB is cautious and data subdued so, despite high US rates and low real return, EUR rates should rise only gradually. Italian policy risk is still a concern for us going into budget season. Although SPGBs have been affected by BTPs, they are a defensive asset with improving fundamentals.

GBP Macro: The release of the UK government’s Brexit white paper will serve as a basis for an enhanced pace of negotiation to occur as the 29 March 2019 exit date approaches. However, we see several elements of the white paper as being essentially contradictory in nature, and we remain concerned by the lack of detail on the future trading arrangements for the UK’s predominant services sector. Critically, until an agreement is achieved on the Northern Ireland backstop, the UK’s orderly withdrawal from the EU cannot be viewed as a given.

GBP Rates: UK rates’ strongest feature in July has been an increasing conviction that an August rate hike is inevitable, with the market now implying at least one hike by the end of this year and short-term receiving positions facing nearly one-way risks. With the UK’s economic and political situation very finely balanced, we believe the MPC will decide that the time is still not right to tighten monetary policy, and the very skewed payoffs make this a view worth trading on.

G-10 FX: A robust economy, rising inflation and interest rate hikes should continue to support the USD. We still expect a steady, but gradual, appreciation in EUR/USD. But, given that trade tensions are viewed, at least for now, as USD positive, a ratcheting up of these threats will pose a risk to the EUR. We continue to believe that the BoE will not hike rates in August. This, together with Brexit uncertainty, should temper investor demand to buy the Pound, even at low levels.

Antonio Villarroya
Head of Macro and Strategy Research
antvillarroya@gruposantander.com

José María Fernández
Rates Strategist
josemariafernandezl@gruposantander.com

Edgar da Silva
Rates Strategist
efda@gruposantander.com

Antonio Espasa
European Chief Economist
aespasa@gruposantander.com

Beatriz Tejero
Economist
beatriz.tejero@gruposantander.com

Laura Velasco
Economist
laura.velasco@gruposantander.com
Banco Santander, S.A.
(+34) 91 257-2244 / 175 2289

Luca Jellinek
Head of Rates and FX Strategy
luca.jellinek@santandergcb.com

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

Adam Dent
UK Rates Strategist
Adam.Dent@santandergcb.com
Banco Santander, S.A. London Branch
(+44) 33 114 80 133 / 239 / 240

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

Michael Flisher
G10 FX Strategist
michael.flisher@santandergcb.com
Banco Santander, S.A. London Branch
(+44) 33 114 80 134 / 232

For a full list of contributors, please refer to page 27

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

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

	USD	EUR	GBP
Economic Outlook	We have revised our GDP estimates for 2018 to 2.8% YoY (from 2.5%) and to 2.7% in 2019 (vs 2.6%) after including the effect of the fiscal reform. We expect a higher fiscal deficit and worse c/a balance	We have reduced our GDP estimate for 2018 to 2.3% (from 2.4%.), while leaving 2019 at 2.2%. Growth in 1Q18 was lower than-expected but fundamentals support 2.0%+ growth in 2018-19 with internal demand as the main driver.	We expect UK GDP growth of c.1.2% in 2018E, with investment constrained by ongoing Brexit uncertainty. Falling inflation should flatter real consumption growth in 2H18.
Monetary Policy / Front-End	The Fed is increasingly likely to hike rates every quarter this year, but we believe it won't be able to raise rates as much as expected by the dot plot in 2019E.	It's now official: the ECB will continue buying bonds until Dec'18 but the first rate hike will not take place until Sep-2019.	We expect Bank Rate to remain at 0.5% through 2018 and no change in QE, with growth and inflation likely to fall short of MPC expectations and Brexit negotiations going slowly.
Rates / Duration	The monetary policy normalisation, healthy macro environment and potential changes in the supply/demand equilibrium should weigh on USTs all along the curve.	EUR rates price in a lot of ECB restraint and risk-off sentiment. Assuming the recovery continues, current market pricing is a good entry point for the slow bond bearish trend.	Short rates and pricing for an imminent BoE hike look too high but longer tenors fair, given the backdrop of heightened Brexit and economic uncertainty.
Curve / Slope	We remain bearish on the front end (pay 2y2y) but continue to prefer carry-efficient shorts in the belly (pay the belly in 2s5s30s).	Overall steepness remains highly directional. Belief in ECB dovishness has rewarded the 5y bucket. We expect moderate flattening.	The long end should perform well on supportive index extensions and no supply. 15-20y has swung from being cheap to rich on the gilt curve.
Spreads	Gradually unwinding SOMA reinvestments pose a risk for USTs. We like swap spread wideners (bearish USTs), especially at the ultra-long end.	SPGBs' solid fundamentals underpin their valuation. BTP spreads have tightened but policy risk remains significant, ahead of the budget season.	Gilt spreads look set to remain wide in illiquid and unsettled summer markets. 7y offers most scope for further widening if stress increases.
Volatility	Ultra-long expiries, and the bottom right corner in particular, are now starting to look rich compared to recent ranges and also to delivered vol.	Although implied vols continue to trail realised levels, the explicit commitment of the ECB to a low-volatility rates environment is difficult to overcome.	Implied volatilities slumped in July, as (premature) confidence built for an immediate hike yet long-run rates increasingly reflected stagnation.
Inflation / Break-evens	After recent market volatility, front-end break-evens are clearly lower (as opposed to the rest of the curve), with no fundamental reasons for this move. We see a buying opportunity there.	Market-implied inflation is very close to fair value, given recent data, oil prices and overall directional momentum. The 5s10s ILS slope, however, looks too flat.	Petrol prices have paused the fall in CPI, but we still expect a move to the 2% target by year-end. Wage growth is still pivotal and underwhelming. 10y linkers look cheap on beta-weighted BE and iota.
FX	The USD gains may have levelled out. Political and trade concerns could still weigh, but the mix of a strong economy and further Fed rate hikes in 2018 should provide some support going forward.	EUR/USD has weakened amid renewed political uncertainty. Soft economic data and EU-US rate spreads may also weigh, but a less loose ECB monetary policy from Q4-18 should be supportive.	Sterling is slipping as the USD regains its footing. Plus, the pound remains vulnerable to slower GDP, CPI and political/Brexit uncertainty. We do not expect the BoE to hike rates.

Source: Santander Economics, Rates and FX Strategy Research. For a full list of contributors, please see contact details on page 27.

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

	USD	EUR	GBP
Govies	**Sell the 30y UST in ASW** Entry level = 18bp. Target level = 30bp. Stop loss = 12bp	**1) Buy SPGB 0.35% Jul-23 vs. OBL 0% Apr-2023** at +73bp. Target +30bp. **2) RASW Schatz 0% Jun-2020** at E -49bp. Target E -40bp.	**1) Buy UKT 24s vs. 23s&25s.** Current level = 3bp. Target = 1bp. Stop = 5bp. **2) UKT 30s40s flattener.** Current level = -11bp, Target = -13bp. Stop = -9bp.
Rates	**1) Pay the belly in 2s5s30s** Entry = 2bp. Target = 6bp. SL= 0bp **2) Pay 2y2y in USD swaps** Entry level = 2.90%.Target = 3.30%. Stop loss = 2.70%	**1) Pay 10y Euribor fixed, receive 10y ILS** at -0.75%. Target -0.45% **2) Pay 2f2y Euribor fixed** at 0.40%. Target 0.60%	**Receive 6m Sonia OIS.** Entry level = 0.70%.Target = 0.60%. Stop loss = 0.73%
FX	**Buy NZD/USD** at 0.6775 target= 0.74, with a stop loss at 0.6463	**Sell EUR/SEK** original entry (Apr-18) at 10.54. Target = 9.50. SL = 11.06.	**Sell GBP/NOK** at 10.75, target= 10.00, with a stop loss at 11.13

Global Strategy: Trade Tensions and Curve Inversions

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

While the economic cycle continues registering record longevity, trade tensions and a gradual removal of monetary accommodation cast doubts regarding the timing and abruptness of the next deceleration. The Fed will probably ignore recent pressures and continue gradually raising rates, but they will probably stop earlier than they currently envisage. With the front end being driven by domestic factors but the global hunt for yield keeping long-end rates from rising faster, the US curve is likely to invert, but a recession does not have to necessarily take place in the aftermath of the upcoming curve inversion.

Rising tensions and the end of the global cycle

The global economic expansion continues, making the present cycle one of the longest in modern history. But bearing in mind that the main driver of this period of sustained growth has been advanced economies' monetary authorities, it seems reasonable that their – albeit slow – withdrawal is raising concerns about the timing and abruptness of the next economic deceleration.

This already challenging outlook is complicated further by trade war threats. According to the IMF, if the current trade policy threats (only incorporating trade actions *that have already been taken*) are realised, and business confidence falls as a result, global output could be c.0.5% below their current projections by 2020. Consequently, any forward indicator potentially signalling the arrival of the end of the cycle is closely watched, hence the focus on the relentless flattening of the US curve (more on this below).

Macro-wise, we have discussed in these pages in the past how, after many years of sequential downward revisions in global growth forecasts, that trend finally changed in the last 18 months, which have at last brought upward revisions. That said, the latest IMF World Economic Outlook update (‘*Less Even Expansion, Rising Trade Tensions*’) sounds much more cautious than in previous months, although not enough to push down the 3.9% global growth forecast for this year and the next (Chart 1).

In fact, the IMF shaves one tenth off this year's growth in advanced economies (AE), with the revision coming mainly from the EU, where 2018 expected growth has been revised downwards by 0.2%-0.3% in the four largest countries- The adjustment is similar for Japan (Table 1) but it is the Latin America growth forecast that suffers the largest downward revision.

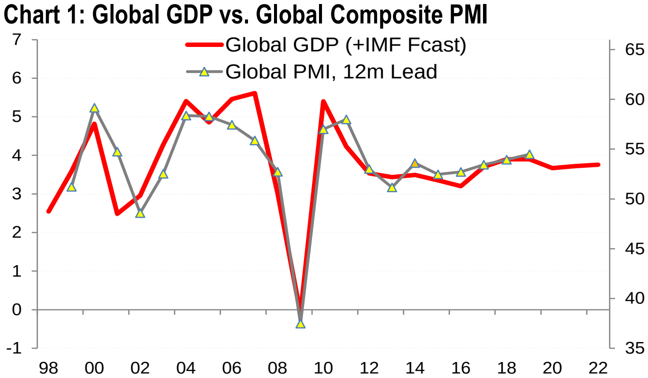
We have discussed previously how the US numbers are artificially boosted by the Tax Cuts and Jobs Act and part of that growth is being simply frontloaded from future years. Even so, most macro indicators continue to show the US economy firing on all cylinders, especially the labour market (see US economy section), which recently registered a new all-time low in unemployment claims, while several of the most closely-watched inflation metrics seem to be finally at or above the Fed's comfort zone (Chart 2).

Table 1: Main economies' expected GDP growth by the IMF (and change vs. April 2018 estimate)

	GDP Growth (yoy)				Δ vs April WEO	
	2016	2017	2018	2019	2018	2019
World Output	**3.2**	**3.7**	**3.9**	**3.9**	**0.0**	**0.0**
Advanced Econ.	**1.7**	**2.4**	**2.4**	**2.2**	**-0.1**	**0.0**
United States	1.5	2.3	2.9	2.7	0.0	0.0
Euro Area	1.8	2.4	2.2	1.9	-0.2	-0.1
Germany	1.9	2.5	2.2	2.1	-0.3	0.1
France	1.1	2.3	1.8	1.7	-0.3	-0.3
Italy	0.9	1.5	1.2	1.0	-0.3	-0.1
Spain	3.3	3.1	2.8	2.2	0.0	0.0
Japan	1.0	1.7	1.0	0.9	-0.2	0.0
United Kingdom	1.8	1.7	1.4	1.5	-0.2	0.0
Canada	1.4	3.0	2.1	2.0	0.0	0.0
EM & Dvlp Econ.	**4.4**	**4.7**	**4.9**	**5.1**	**0.0**	**0.0**
Russia	-0.2	1.5	1.7	1.5	0.0	0.0
Emrg & Dvlp Asia	6.5	6.5	6.5	6.5	0.0	-0.1
China	6.7	6.9	6.6	6.4	0.0	0.0
India	7.1	6.7	7.3	7.5	-0.1	-0.3
Em & Dev Europe	3.2	5.9	4.3	3.6	0.0	-0.1
Latin America	-0.6	1.3	1.6	2.6	-0.4	-0.2

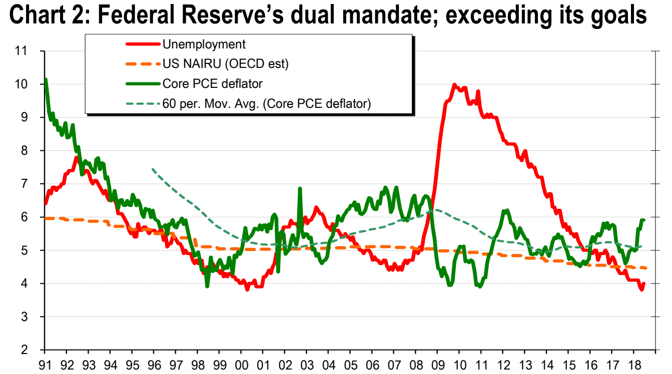
Source: IMF, Santander.

Chart 1: Global GDP vs. Global Composite PMI



Source: Santander, IMF

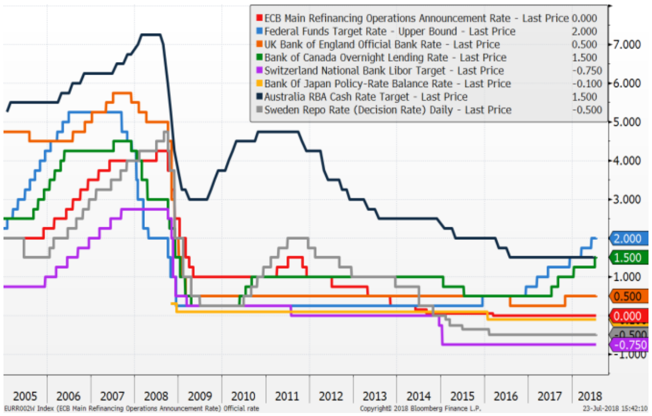
Chart 2: Federal Reserve's dual mandate; exceeding its goals



Source: Santander, Bloomberg

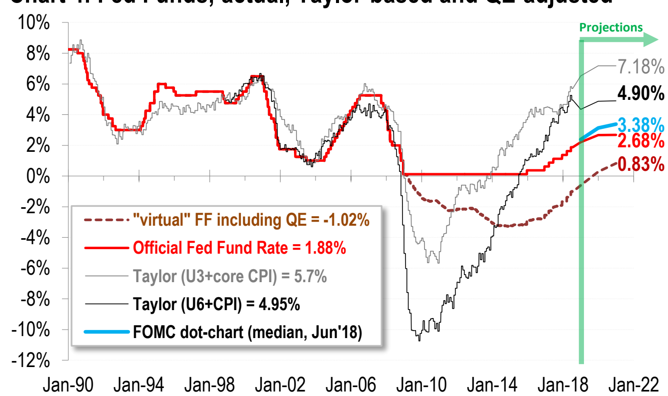
Given this domestic environment, the **Federal Reserve** remains on track to continue removing its monetary accommodation, but it is still practically the only major central bank raising rates, only followed - at some distance - by the BoC (Chart 3). And it has further to go, as the Fed's current monetary stance is still accommodative, especially once we take its much larger balance sheet into account (c.$4.3trn vs. $1trn before the GFC). According to our analysis, following the Atlanta Fed methodology, **QE-adjusted official rates in the US are currently still around zero** (Chart 4). And even taking the ongoing gradual decline in the Fed's balance sheet and rate hikes into consideration, its monetary policy will remain accommodative for a while.

Chart 3: Main advanced economies' official rates



Source: Bloomberg, Santander

Chart 4: Fed Funds; actual, Taylor-based and QE-adjusted



Source: Federal Reserve, Santander

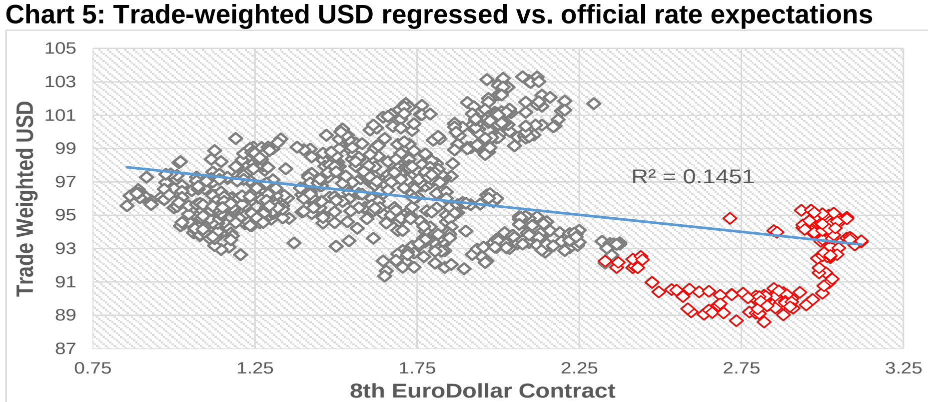
As explained last month, our concern is that, with structural core inflation far from being a problem, the ongoing trade tensions and their potential adverse effects on confidence, markets and investment (plus the asymmetrical risk if the US economy slows down significantly once the fiscal easing impact stops helping the economy), **we think there is no need to take official rates above what most Fed members consider the longer run level, i.e. not above 3%.**

Managing external pressures

We think **the Fed should ignore the recent 'political pressures' against raising rates further:** not too long ago the criticism was the other way around, i.e. against keeping rates too low. But this rhetoric is probably more aimed at the impact of higher rates on the USD, given the US government focus on trade, tariffs and competitiveness ahead of the mid-term elections.

And with the US economy performing well, a very strong 2Q18 GDP figure and stock markets near all-time highs, **there is no compelling reason not to continue with the gradual removal of accommodation** (we expect two more hikes this year), while any perception of political interference will not be positive for this institution. Furthermore, regarding its impact on the USD, the R2 between the USD (trade-weighted) and expected official rates (8th ED contract) since the Fed started raising rates is a very poor 0.15x (See chart 5).

Chart 5: Trade-weighted USD regressed vs. official rate expectations



Source: Bloomberg, Santander

On the other hand, as mentioned by its Chairman in previous occasions, we think the Fed should be relatively relaxed about the possibility of a temporary above-target inflation rate, and therefore eventually hike official rates less than expected by its members, given also the asymmetrical risks of an excessive tightening and the likely USD curve inversion.

Plus, we should not forget the huge amount of deficit to finance at higher rates and the gargantuan amount of public debt that would make any sizeable fiscal easing almost impossible should the economy decelerate sharply.

Recessions and curve inversion: causality or simply precedence

All these factors have increased the **focus on the US curve, more specifically, its slope and the likelihood and implications of an inverted yield curve**. Financial literature and empirical analysis very clearly show the relationship between both events, highlighting how cycles tend to end when the monetary tightening, normally trying to contain rising inflation caused by above-potential growth, puts the final nail in the cycle's coffin. Nevertheless, in our view, there are two important differences between the present cycle and previous ones, despite the much larger monetary easing on this occasion.

The first is the much lower inflationary pressure for a given level of growth and labour market conditions. In the past we have discussed globalisation and flat Phillips curves. Recently Stuart Green also argued (The UK Phillips Curve – Missing inaction? 16 July 2018) that the shorter period of time in between jobs has probably exaggerated the reported decline in the unemployment rate, what would be consistent with a lower NAIRU.

Table 2: FOMC dots and possible split between voters and non-voters

Upper End Fed Funds	Dec-18 Dots	Dec-18 o/w Voters	Dec-19 Dots	Dec-19 o/w Voters
2.00%	2	0	1	1
2.25%	5	2	1	0
2.50%	7	6	0	0
2.75%	1	1	1	1
3.00%			4	1
3.25%			4	3
3.50%			3	2
3.75%			1	1
Median	2.50%	2.50%	3.25%	3.25%
Average	2.37%	2.47%	3.08%	3.14%

Source: Bloomberg

Although the recent US-driven protectionist impulse could endanger this benefit, **we believe global consumer inflation is much more unlikely to become a structural concern than in previous cycles**, hence all the recent discussion regarding lower terminal rates (r*).

On the other hand, as discussed in the US rates section of last month's I&E, **the current slope of the curve is affected by the structural reduction in term premia caused by official asset purchases** and, therefore, its relationship with macro fundamentals should be different now.

Although the peak is behind, the sizeable accumulation of fixed income assets by the largest monetary authorities not only has had, but continues to have, a significant impact on their yields (given the price-inelastic demand), while global international competition for yield has become very significant.

Whether currency-hedged or not, **the fact that 10y government bonds yield around 10bp in Japan, 40bp in Germany, 70bp in France or 1.35% in Spain contributes to keep US Treasury yields from rising significantly**, despite the strong US macro and large funding needs. This global 'connection' would be reinforced by the recent slight steeping in US and EUR curves allegedly driven by the BoJ news.

As an aside, we think the BoJ is very far from ending its 'yield curve control' regime for good, and although it might show some flexibility in its c.0% target for 10-year yields or the amounts purchased every month, the truth is that it does not make much sense to have two tools to keep yields from rising (contingent fixed-rate reverse auctions together with actual monthly purchases).

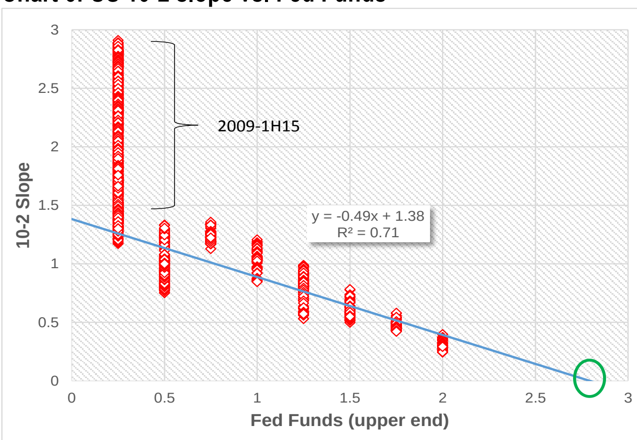
Coming back to the US curve, and according to the analysis carried out last month, without these global yield competition drivers the UST 10-2 should now be north of 100bp, vs. 30bp at the time of writing.

We agree with many of the arguments put forward by Minneapolis Fed President Neal Kashkari and the dangers of the 'this time is different' wording (see The Flattening Yield Curve) and the risk of "moving to a contractionary policy stance and putting the brakes on the economy" but as highlighted above, global QE is helping to keep global curves flatter than they otherwise would be.

The US curve is likely to invert in coming months – especially if the Fed follows its own median projections (as seen Chart 6) **– as the front end seems driven mostly by domestic factors vs. the 'more global' long end drivers.** Macro wise, the main risk to our official rates call is the global trade uncertainty that, according to the last Beige Book, was starting to impact investment decisions as 'manufacturers in all districts expressed concerns about tariffs'.

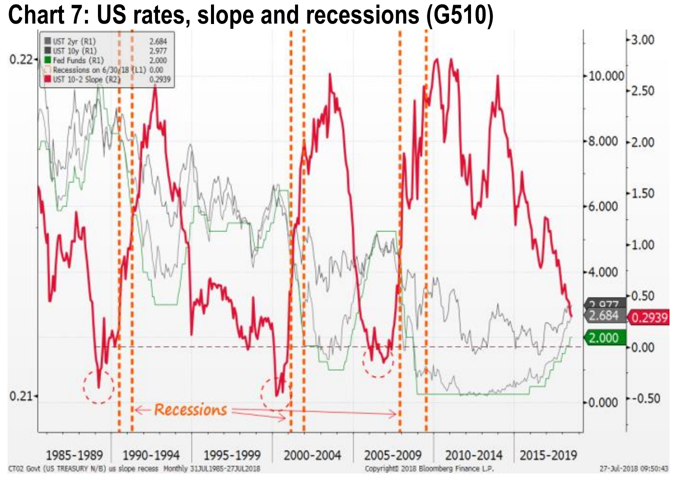
Given all these factors, **we will take the ominous perception that indefectibly links a flat or inverted US curve with a recession in the next 12-24 months with a pinch of salt** (Chart 7).

Chart 6: US 10-2 slope vs. Fed Funds



Source: Bloomberg, Santander

Chart 7: US rates, slope and recessions (G510)



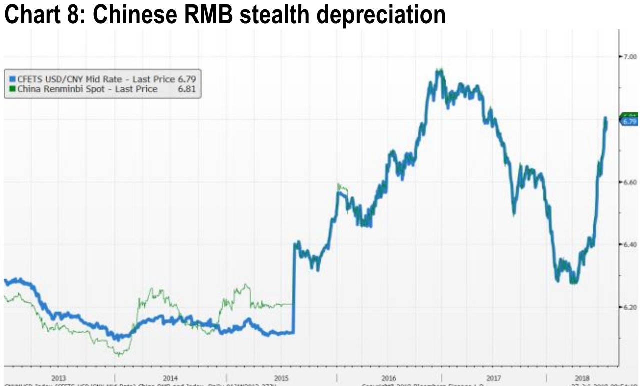
Source: Bloomberg, Santander

No changes in our macro and rates calls, 'for now'

This degree of macroeconomic uncertainty was probably reflected in the recent qualification of the Fed's intentions when it said that "the FOMC believes that -- **for now** --the best way forward is to keep gradually raising the federal funds rate". Besides the above-mentioned BoJ meeting (31 July) and upcoming tariff-related meetings and announcements - and with the ECB unlikely to provide relevant market news for a while -, we will also keep an eye on oil prices, RMB (Chart 8) but also international govie yields and UST holdings.

In this regard, while Russia seems to have dumped a good chunk of its UST holdings (see Table 3), total US Treasury securities foreign holdings stand at around all-time highs, at $6.2trn (c.37% of this market), with the UK and Brazil holdings are at record levels, although for different reasons. Regarding the former, the absolute level paid by USTs is obviously a key driver for UK-based asset managers, and is probably also behind the increase in foreign holdings of US T-bills (+$50bn in the last 18 months). At the end of the day, at 2.3%, a 12-month US bill pays more than many long-end government bonds in developed countries (or the S&P 500 dividend yield).

Chart 8: Chinese RMB stealth depreciation



Source: Santander

Table 3: International holdings of UST securities (USD bn)

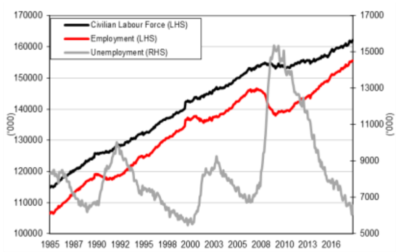
	May-18	Dec-17	Dec-16	Dec-15
Japan	1,049	1,062	1,091	1,122
China	1,183	1,185	1,058	1,246
UK	265	250	217	207
Ireland	301	327	288	264
Brazi	299	257	259	255
Cayman	186	171	261	250
Switz	243	250	230	232
Luxem	209	218	224	200
Russi	15	102	86	92
Belgi	151	119	120	122
Total	6,214	6,210	6,003	6,146
Of w/ official	**3,991**	**4,026**	**3,814**	**4,094**
Bills	346	317	298	337
Bonds / notes	3,645	3,709	3,516	3,757

Source; US Treasury TIC data

Antonio Espasa
(+34) 91 289 3313

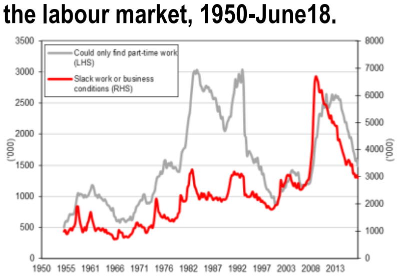
The US labour market is tightening very fast. Job creation remains strong, while working population growth rates are limited by the still low labour participation ratios. The unemployment rate could surprise on the downside in 2019E. The goods-producing sector leads the adjustment, while the services sector is still lagging. We expect this pressure in the labour market to translate into rising earnings per hour in coming quarters, possibly surprising the market on the upside and raising concerns about future inflation.

Chart 9: Employment, unemployment and working population, 1985-June18



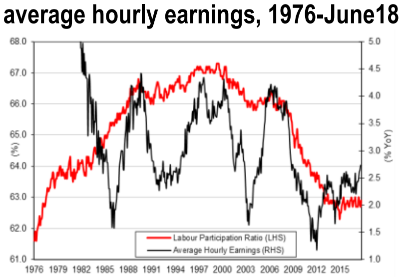
Source: BLS and Santander.

Chart 10: Measures of the slack in the labour market, 1950-June18.



Source: Datastream and Santander.

Chart 11: Labour participation ratio vs. average hourly earnings, 1976-June18



Source: Datastream and Santander.

The US labour market is getting tighter

The adjustment of the US labour market is running at full speed, leading to a significant tightening between supply and demand. The unemployment rate remains at around 4.0% of the working population, after having broken through that level in recent months and dipping to 3.8% in May this year. Looking at historical records, we would have to go back to 1969 to see a lower level of unemployment. Moreover, if employment creation remains at around 200k new jobs per month, as has been the case over the last year, we estimate that the unemployment rate could drop even further, to below 3.5% by the end of 2019E.

In our view, this tightening of the labour market could have significant implications going forward for both growth and inflation. Moreover, it could finally have an impact on the Federal Reserve's monetary policy decisions.

Job creation remains quite strong…

The dynamism of the labour market continues. Job creation has posted very healthy growth rates in recent years and is likely to keep on doing so in the near future. In that regard, the fiscal package already in place is pushing final demand higher and consequently production has to follow, which in the end has a very positive impact on employment creation. According to the household survey, employment grew by 1.5% YoY in June, versus 1.4% in the last twelve months. After decelerating to 1.3% in 2017 from 1.7% in 2014-16, we expect job creation to pick up to 1.6% in 2018E and 1.7% in 2019E.

Most of jobs created are in the services sector, although the sector showing the strongest growth in employment in recent months is the goods-producing sector, which accounts for around 14% of total non-farm employment. Employment creation in this sector grew by 3.1% in June, versus 2.4% in the last twelve months, 1.7% in 2017 and just 0.7% in 2016. The acceleration of activity is pushing employment upwards in both construction (4.1% in June and 3.5% in the last twelve months) and manufacturing (2.3% in June and 13.5% in the last twelve months). The services sector, despite being responsible for most of the jobs being created in the economy, given its weight, shows slower growth rates: 1.4% in June versus 1.4% in the last twelve months and 1.6% in 2017.

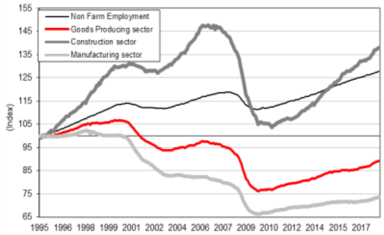
The strong job creation rates and the limited growth of the workforce (1.2% in June and 0.8% in the last twelve months), due in part to the still low labour participation ratios (62.9% in June versus 62.8% on average since 2015), have driven down the unemployment rate and could continue to do so in the coming quarters.

We expect the unemployment rate to fall to an average of 4.0% in 2018E and 3.5% in 2019E (vs. 4.4% in 2017 and 4.9% in 2016). Regarding the workforce, we forecast an increase of 1.2% in both 2018E and 2019E, from just 0.7% in 2017. That means that we are moving towards a very tight labour market, in which only an increase in labour participation rates could help alleviate the current pressure.

…with the goods-producing sector accelerating…

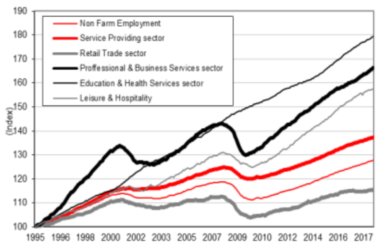
The goods-producing sector has generated 624k new jobs in the last twelve months, the greatest annual increase in the sector since January 1998. The number of jobs generated this year is even more significant, representing 3.0% of the total employment in the sector (20,672k), while the 644k new jobs generated in January 1998 represented 2.7% of the total (24,262k).

Chart 12: Indices of employment in the goods-producing sector, 1995-June18



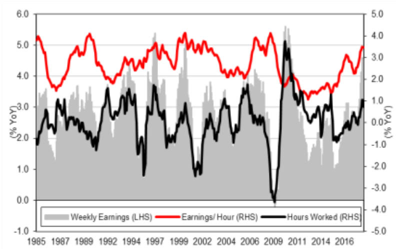
Source: NPA, Datastream and Santander.

Chart 13: Indices of employment in the services sector, 1995-June18



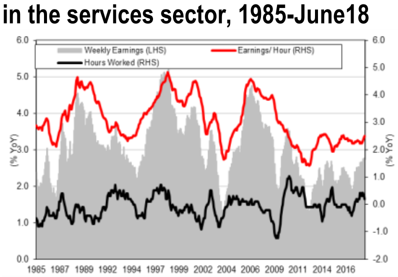
Source: Datastream and Santander.

Chart 14: Earnings and hours worked in the goods-producing sector, 1985-June18



Source: Conference Board and Santander.

Chart 15: Earnings and hours worked in the services sector, 1985-June18



Source: Datastream and Santander.

The breakdown of the goods-producing sector shows that 45% of the new jobs (624k) generated in the last year were in construction (282k) and 46% in manufacturing (285k), while the rest came from natural resources and mining (57k).

In our view, the sector should keep on generating jobs at the same pace in coming quarters, putting more upward pressure on salaries in the sector. The main risk could come from the uncertainty arising from the trade war, which would affect corporate decisions on employment creation and investment.

…and the services sector lagging.

The employment growth rates in the services sector (1.4% in June versus 1.4% in the last twelve months and 1.6% in 2017) are more modest than those of the goods-producing sector. 1,750k new jobs have been created in the last twelve months, taking the total in the sector to 128,240k. While certain sub-sectors in the services industry have shown stronger growth rates (building material and garden supply stores, non-store retailers, transportation and warehousing, real estate, and professional and business services in particular), others are still posting negative numbers, such as retail trade or information. Government employment also remains very weak.

An acceleration of private consumption in 2H18E could push up job creation rates in some of the services sub-sectors directly linked to consumption, although structural changes such as replacement of labour by capital in certain areas could keep those rates at modest levels in the medium term.

Hourly earnings are likely to accelerate as a result

With the labour market getting tighter, we expect that pressure to translate into stronger growth in hourly wages in the coming quarters. Growth in earnings per hour has quickened in recent months, with the annual growth rate of 2.7% in June marking the fastest pace since August 2009 (2.8%). We believe that growth rates could speed up even further in 3Q18E, approaching the 3.0% level. We forecast an increase in earnings per hour of 2.6% in 2018E (from 2.3% in 2017), with risks being on the upside, while we expect a rise of 2.9% in 2019E, also with upward risk to our numbers.

Interestingly, as was the case with employment creation, the main driver of the acceleration in earnings per hour has been the goods-producing sector, which saw an annual growth rate in June of 3.5%, which is the strongest growth rate since the 3.6% posted in April 2009. Earnings are on the rise in the sector, showing an increase of 2.9% in the last twelve months. The main drivers of the acceleration have been construction (3.7% in June and 3.2% in the last 12m) and manufacturing (3.0% in June and 2.6% in the last 12m).

The private services sector is lagging in terms of hourly earnings, with an annual growth rate of 2.5% in June (2.3% in the last twelve months) Despite some sub-sectors reporting substantial growth in hourly earnings, for the sector as a whole earnings growth remains low by historical standards. This rate will need to increase if there is to be an acceleration in total earnings per hour, given services' weight in total employment. We expect this to progressively materialise going into 2019E.

US Rates Strategy: Trade opportunities after the recent sell-off

José María Fernández
(+34) 91 257 2244

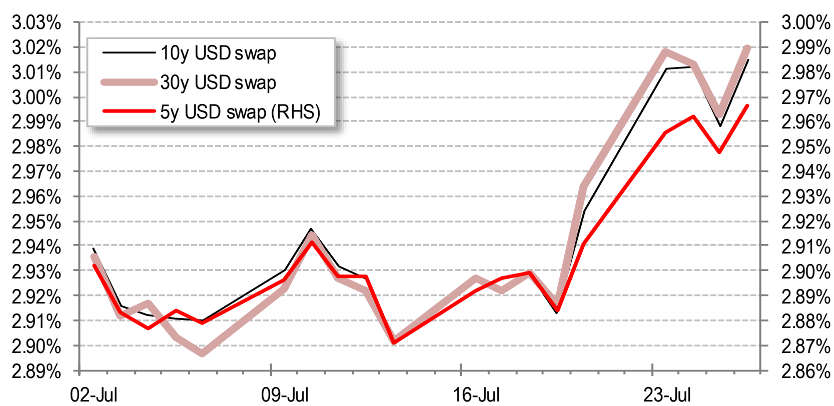
- **After several weeks of trading within very narrow ranges, apparently immune to the trade-war related headlines and other possible non-US event risks, medium- and long-term US rates have finally come back to life.**
- **While moving in the right direction, we still do not see the recent spike in US rates as the beginning of an imminent bearish trend. Nevertheless, this fast market move has created some dislocations that, in our view, should correct in the short run.**
- **We maintain our approach of being short through carry-efficient alternatives and recommend taking advantage of these dislocations by paying the belly in 2s5s30s in USD swaps.**

Not Trump, not the Fed, not Europe…news coming from Japan is what has finally made US rates move

After several weeks of trading within very narrow ranges, apparently immune to the trade-war related headlines and other possible non-US event risks, medium- and long-term US rates have finally come back to life on the back of recent news suggesting that the BoJ might be debating the possibility of reducing the amount of monetary stimulus in Japan. The importance the market seems to have given to this specific topic is rather surprising, in our view (especially when compared to the null reaction to news related to other inherent risks for USTs, like gradually increasing funding needs or declining demand from the Fed), bearing in mind that the BoJ is in any event very likely to maintain a high level of stimulus in the quarters to come (inflation data for June, published just a few days ago, surprised to the downside and for the time being do not show any clear signs of material inflationary pressure building up in the country).

In any case, this has caused a spike in US rates in the past few sessions that took swap rates back to the 3% area for the first time since May, with the long end of the curve apparently leading the move, as suggested by a visual comparison of recent ranges vs. the spike seen in the past few sessions (see Chart 16).

Chart 16: Evolution of USD swap rates: current levels vs. recent ranges



Source: Bloomberg, Santander.

At this point, we find two big questions arising out of this price action: will this event prove to be the beginning of the long-awaited bearish trend for US rates this year? And, also very importantly, have these fast movements, in a context of reduced liquidity, generated any dislocation that can be played in the market?

But has anything changed at all?

As discussed in the global strategy section, **we are not changing our call on the Fed or US rates for the remainder of the year, at least for now**.

A sudden change in the global accommodation delivered by major central banks might, of course, have major implications for government bond markets (and it is only natural that the market reflects investors' concerns about any hint of potential changes on this front). But the news so far seems to suggest that the BoJ might consider just fine-tuning its existing tools rather than making massive changes to its overall very accommodative stance. We agree that the risk stemming from a significant change in global liquidity (or in the pricing of global fixed-income assets) is bearish for USTs, but recent developments do not look like a clear trigger for that kind of change, at least not yet.

On the other hand, the uncertainty about the potential extent (and future macro impact) of the current tariff dispute between China and the US is likely to keep on weighing on investors' confidence and might continue to maintain safe-haven assets well bid for some time. As long as this risk persists, we think US rates could try and trade slightly higher than now, but we would still expect any upward pressure to lack conviction.

As a result, **we maintain our forecasts unchanged for medium- and long-term rates, with our projections for this quarter very close to current levels and only suggesting a gradual increase in Q4** (10y UST currently at 2.97%, vs. 3.05% and 3.25% SAN projections for Q3 and Q4, respectively). Note that, as shown in Table 5, our forecasts remain well above current forward levels all along the curve, suggesting an overall bearish positioning in US rates in any case.

The front end, on the contrary, still offers potential for additional increases as the FF curve continues to underprice the pace of hikes suggested by the FOMC dot chart. As explained in detail last month, we think the Fed might finally hike in 2019 and 2020 a little less than currently indicated by those dots, but our call is still more hawkish than current market pricing. That is reflected in our forecasts (2y UST at 2.67%, vs. 2.80% and 3.05% SAN projections for Q3 and Q4, respectively).

Table 4: UST yields: SAN forecasts (%)

USTs yields	Current	3Q18	4Q18	1Q19	2Q19	3Q19	4Q19
Fed Funds	1.875	2.125	2.375	2.625	2.875	2.875	2.875
3m	1.98	2.15	2.40	2.65	2.90	3.00	3.10
2y	2.67	2.80	3.05	3.25	3.40	3.50	3.60
5y	2.85	2.95	3.20	3.45	3.60	3.65	3.70
10y	2.97	3.05	3.25	3.45	3.60	3.70	3.80
30y	3.09	3.15	3.30	3.45	3.55	3.60	3.65

Source: Bloomberg, Santander.

Table 5: UST yields: SAN forecasts – forward rates (bp)

USTs-Fwd	3Q18	4Q18	1Q19	2Q19	3Q19	4Q19
Fed Funds	-4	4	15	28	18	18
3m	-12	-13	6	4	3	16
2y	3	19	34	45	53	63
5y	5	25	47	59	63	67
10y	5	22	40	54	63	72
30y	4	18	32	42	46	51

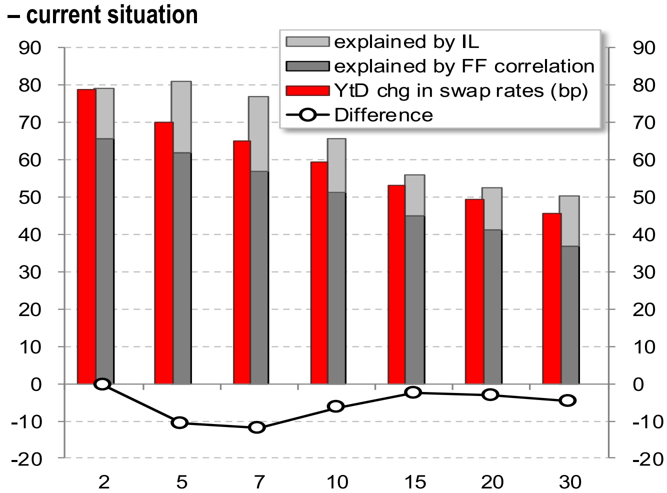
Source: Bloomberg, Santander.

Looking for possible dislocations after the fast move: the 5-7y area looks attractive for tactical shorts

As in previous episodes of sudden market moves earlier this year, we find it interesting to analyse the recent price action by comparing the evolution of nominal rates, monetary policy expectations and inflation expectations. This analysis allows us to identify what tenors in the swap curve offer value by comparing their market changes to those consistent with the shift in underlying fundamentals. As we explained in our April I&E, this kind of analysis, while simple, has worked very well as regards anticipating possible market dislocations in USD rates since January.

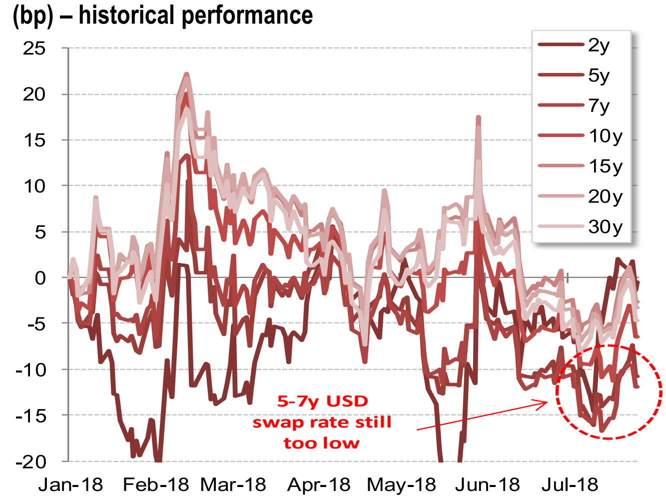
As shown in Chart 17, the cumulative year-to-date shift in USD swap rates seems to be essentially explained by the combination of changes in monetary policy (as measured by FF futures) and inflation (as measured by IL swaps) expectations at the very front end and also in the belly and the long end of the curve. But the 5-7y tenors seem to have lagged in the recent spike, as they did not increase as much as would have been consistent with the changes in FF futures and IL swaps, based on historical correlations.

Chart 17: Dislocations in USD swap rates compared to YtD changes in (beta-weighted) FF futures and in USD IL swaps (bp) – current situation



Source: Bloomberg, Santander.

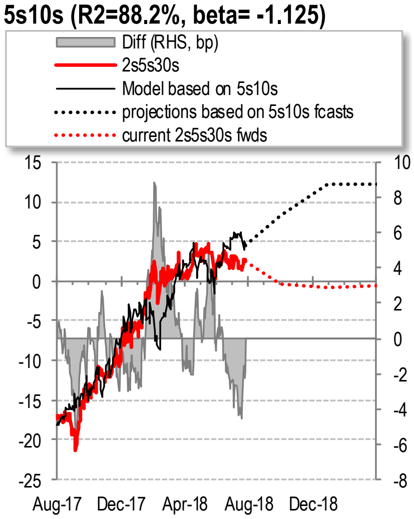
Chart 18: Dislocations in USD swap rates compared to YtD changes in (beta-weighted) FF futures and in USD IL swaps (bp) – historical performance



Source: Bloomberg, Santander.

Play it through 5s10s flatteners… or pay the belly in 2s5s30s as a carry-efficient alternative

Chart 19: 2s5s30s, highly correlated to 5s10s (R2=88.2%, beta= -1.125)



Source: Bloomberg, Santander.

The gap is not huge (approximately 10bp), but it is big enough to represent a good entry point to play, for instance, 5s10s flatteners in the USD swap curve. This is a trade that in our view offers value as we continue to see a risk of flat (or even slightly inverted curves) in the US as the Fed continues to hike rates in coming quarters.

Unfortunately, a 5s10s flattener position yields a slightly negative carry (3m carry = -1.5bp, 3m roll-down = 0.0bp). We have looked for alternative trades that, while maintaining a high correlation to 5s10s, improve the carry and roll-down profile of the position.

As a result of this analysis, we continue to recommend paying the belly in 2s5s30s at 2.5bp. This is a trade we already recommended last month with a target at 6bp; we are now revising it up to 8.5bp (a level consistent with a flat 5s10s, according to their historical correlation). Note that, taking into account the correlation beta, this position improves the 5s10s carry and roll-down by 6.5bp:

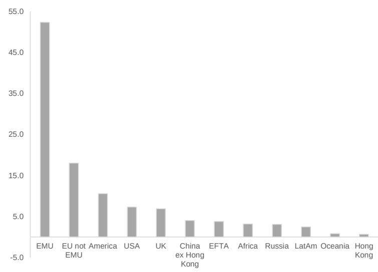
Trade idea: Pay the belly in 2s5s30s USD swaps
Entry level = 2.5bp. Target = 8.5bp. Stop-loss = 0bp
3m carry = 2.8bp. 3m roll-down = 2.2bp

Eurozone Economic Outlook

Beatriz Tejero
(+34) 91 257 21 76

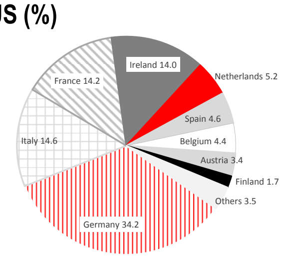
The protectionist measures announced so far by the US should have a limited impact on Eurozone exports, focusing largely on those from Germany and on the autos and machinery sectors. However, we could see negative "second round effects" consisting of a loss of business confidence that would adversely affect investments and growth in the coming months.

Chart 20: Eurozone exports by main destinations (%).



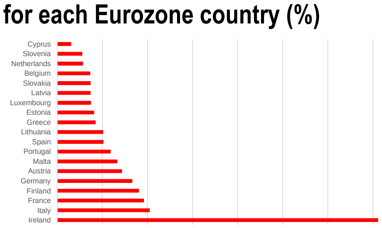
Source: Eurostat, Santander.

Chart 21: Main Eurozone exporters to the US (%)



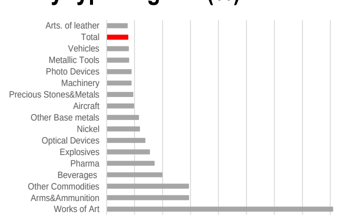
Source: Eurostat, Santander

Chart 22: Share of exports to the US for each Eurozone country (%)



Source: Eurostat, Santander.

Chart 23: Share of EU exports to the US by type of good (%)



Source: Eurostat, Santander.

Possible impact of a trade war on European growth

The new US administration has been adopting protectionist measures in an attempt to reduce the trade deficit that knocked almost 1% off US GDP in 1Q18. These measures have initially been aimed at reducing imports from China and the EU. In the case of the Eurozone, the US administration has so far applied 25% tariffs on steel imports, 10% on aluminium imports and has stated that 20% tariffs could also be charged on imports of European cars. For now, Eurozone exports have not been eroded by the application of these tariffs and they rose by 0.2% MoM in May. However, we intend to track Eurozone exports by product and destination to see if any additional protectionist measures significantly harm Eurozone growth.

EU exports are resilient…

The EU and the Eurozone are endogamous areas from the point of view of trade, since in both cases almost 52% of exports remain in the area. Moreover, the trade balance has been in positive territory since 2011 and has been growing in line with GDP since then. The free trade area supports export growth and hence GDP. In short, it gives resiliency to the EU and Eurozone economy.

In 2017 the EU exported goods amounting to USD0.4bn to the US, representing 7.1% of total EU exports and 16.5% of US imports. The Eurozone exported USD0.35bn worth to the US (16.5% of total US imports and 6.9% of total Eurozone exports). The main exporters to the US are Germany, Italy and France (34.2%, 14.8% and 14.2% of total Eurozone exports to the US, respectively). This means that in theory the impact of the US tariffs on the EU and Eurozone economies should be rather limited.

…but the impact of the tariffs varies depending on the country and sector

However, the impact by country and sector is quite uneven. Note in the chart on the left that exports to the US represent almost 35.5% of Irish exports, while Eurozone exports to the US account for 7.2% of the total. Exports to the US make up between 5% and 10% of total exports for Italy, France, Finland, Germany, Austria, Malta and Portugal, so in general, except in the case of Ireland, the effect of the tariffs imposed by the US on imports from the Eurozone should be limited.

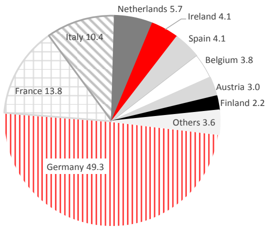
The chart on the left shows the main exports from the EU to the US by type of good. Note that almost half of the works of art that are exported by the Eurozone (and 80% of the works of art exported by the EU) are destined for the US. It is also worth noting that steel and aluminium, on which the US has imposed tariffs, represent 3.7% and 3.0%, respectively, of the Eurozone's total exports of these two products and 0.035% and 0.09% of the total exports of the Eurozone, respectively.

According to the latest messages from the US administration, additional tariffs could be imposed on cars imported from the Eurozone. In 2017 cars exported to the US represented 7.6% of the Eurozone's total car exports and 0.9% of its total exports. Assuming a 20% tariff on car imports from the Eurozone and that this tariff reduced the Eurozone's car exports to the US by a similar 20%, exports to the US would decline by 2.6% and the Eurozone's total exports would fall by 0.18%.

In this case the hardest hit in the Eurozone would be Germany, since 35% of the cars exported by the Eurozone come from Germany and 11.8% of Germany's car exports go to the US. Note, however, that car exports to the

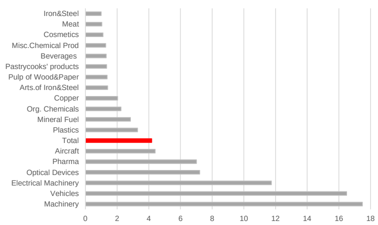
US represent 2% of total German exports, so even though a hypothetical tariff on car imports from the Eurozone would have a greater impact on Germany, this negative effect would also be limited.

Chart 24: Main Eurozone exporters to China (%)



Source: Eurostat, Santander.

Chart 25: Share of EU exports to China by type of good (%)



Source: Eurostat, Santander.

The effects on European activity of the tariffs imposed on Chinese goods should be limited

The US has also imposed tariffs on imports from China and this has given rise to concerns about the impact of a potential deceleration of Chinese investment and activity on Eurozone growth. In fact, exports to China accounted for 4.1% of total Eurozone exports in 2017, so even if the tariffs on imports from China brought in by the US administration resulted in a significant slowdown of the Chinese economy, the impact on the Eurozone's growth should be small.

Any slowdown in exports to China would affect Germany the most since German exports comprise half of the Eurozone's exports to this country, although these exports account for only 6.7% of the total for Germany.

By type of good, machinery and vehicles make up the lion's share of EU exports to China (almost 50% of EU exports to the Asian country belong to these sectors), meaning that any slowdown in industrial activity in China or in cyclical consumption will hurt the Eurozone exports to China the most.

Other remarks on the trade war

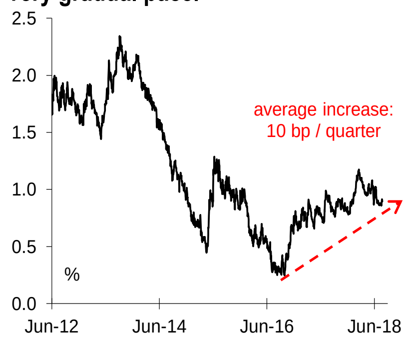
1. As far as the tariffs imposed so far by the US administration on imports from the Eurozone are concerned, we conclude that the trade war should have a limited impact on the Eurozone economy, although the effects will be uneven and especially concentrated on the auto industry and Germany.
2. The impact of the tariffs on the Chinese economy remain to be seen, but the effect on Eurozone exports to China will be concentrated mainly on Germany, Italy and France and on the autos and machinery segments, although they account for (both in geographical and sector terms) a very small proportion of Eurozone exports.
3. However, there could be "second round effects". On the one hand, the tariffs on imports of iron and aluminium are likely to increase production costs in the industrial sector. This, together with the fact that 15.9% of US exports are re-exports, could have a very negative impact on the margins of US companies.
4. If the trade war intensifies, we could see an erosion of business confidence indicators that would negatively affect or at least delay the investment decisions of US, Eurozone and Chinese companies, thus limiting growth in the coming quarters.

Euro Rates Strategy: Summer lull and lingering periphery risk

Luca Jellinek
(+44) 33 114 80133

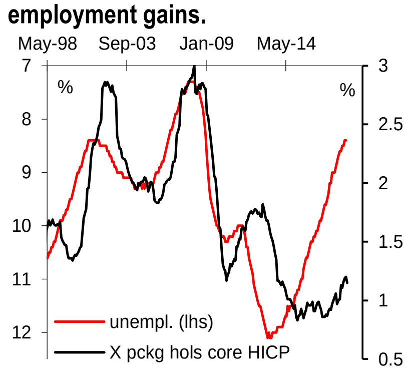
- **With the ECB being quite cautious and data relatively subdued, the rise in EUR rates continues to be very gradual. We currently recommend being short real rates (10y) and a directional 5s30s flattener.**
- **Italian policy risk has been repriced lower but we think it is still a concern going into budget season.**
- **Although SPGBs have shown some contagion effects, they remain a strong, defensive asset with improving fundamentals. The 10y area looks attractive vs. Bunds.**

Chart 26: EUR rates increasing at a very gradual pace.



Source: Bloomberg, Santander

Chart 27: Euro inflation still lagging employment gains.



Source: Bloomberg, Eurostat, Santander

Slow bear trend requires low-cost positioning.

Since we last wrote in some detail about core EUR rates direction, on 20 July, price action has become slightly less boring and sideways, with both nominal and real rates showing some upside in the bellwether 10y tenor. Nonetheless, the big picture in EUR rates remains one of limited volatility, with the 10y rate rising by an average of just 10bp per quarter since the all-time low set in Q4-16 (chart 26). In short, the explanation for such subdued directionality is based on several factors:

- At 2.5%, GDP growth is above potential, thus compressing the output gap, but it has slowed since 2017 and indicators like the PMI and Economic Confidence survey have come off their 2017 peak, too. The increasing risk of damaging trade disputes between the US-EU and EU-Britain, among other factors, threaten export and investment growth.
- Ongoing improvements in employment have yet to translate fully into higher wages and price growth (chart 27). In turn, this has contributed to a very dovish, 'patient, prudent and persistent' monetary policy outlook. Regardless of the exact timing of the first ECB rate hike, the market remains convinced that the pace of hiking will be sub-40bp per year.
- 'Risk-off' concerns, whether domestically due to political risk in Europe, or more globally, given the massive global debt overhang, underpin lingering safe-haven-seeking investor behaviour.

Overall, barring an actual economic downturn in the G10, we expect the ECB to eventually increase policy rates, underlying inflation rates to grind closer to 1.5%-2% and term rates to rise commensurately. However, the pace of the increase, punctuated by occasional sell-offs, can be expected to be very slow in the future, as it has been for the past couple of years. In such an environment, positioning should reflect areas of particular relative value as well as carry considerations. We have two current trade recommendations in this space, which we believe are still attractive.

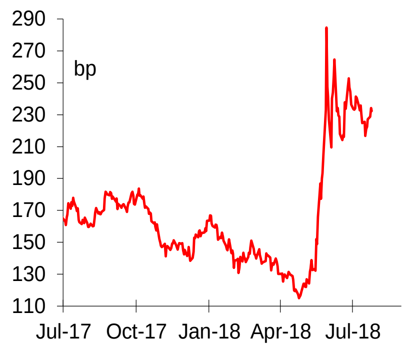
<u>Trade idea:</u> Higher 10y real rates

Pay 10y Euribor IRS and receive 10y ILS (EMU ex-tob. HICP). The real 10y Euribor rate is -0.71% and we target -0.45%.

<u>Trade idea:</u> EUR 5s30s 'bearish' flattener

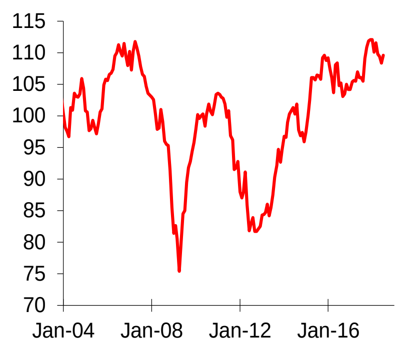
Pay 5y IRS fixed and receive 30y IRS fixed. The current spread is 120bp. We target a test, then break, of the recent 106bp low. The 3-month carry cost on such a flattener is roughly 1bp..

Chart 28: 10y CMT spread BTP-Bund



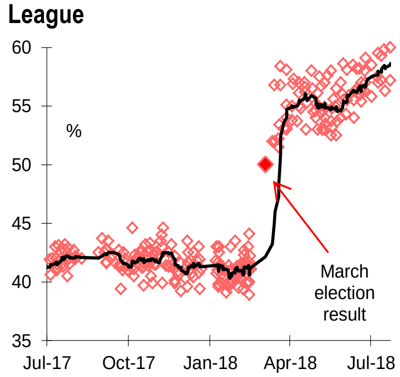
Source: Bloomberg, Santander

Chart 29: Italian economic confidence survey



Source: EC, Santander

Chart 30: Poll readings: 5-Star + League



Source: Pollsters, Santander

Periphery: the 'Italy question' remains very relevant

A big-picture, top-down take on periphery sovereign spreads could be summarised by two statements:

1. Since May of this year, the size and volatility of premia have entered a new, riskier regime.
2. That move has been led almost entirely by poorer Italian risk perception, following the formation of a new government.

If we accept that premise, **the two key questions in the near future are whether Italy risk premia will remain elevated and to what extent other periphery issuers can overcome that challenge.**

BTP-Bund yield spreads are well below their late-May peaks and have been grinding lower for much of June and July. Looking at the high-volatility 5y maturity, the wide point was around 340bp and at the time of writing had shrunk back to around 205bp. The more typical benchmark 10y maturity saw spreads peak around 290bp and is now closer to 230bp.

A number of positive considerations support the idea of Italian yield convergence. First of all, there is **no evidence yet in economic data** that the long post-electoral transition and eventual formation of a less 'mainstream' government have had a **negative impact distinguishable from the generalised deceleration of Euro area growth**. Similarly, fiscal figures have continued on their gradually improving path, to date.

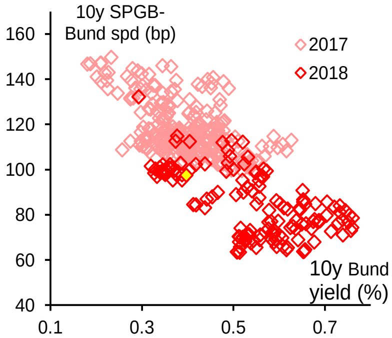
The appointment of well-qualified, orthodox technocrats in some key posts, including the Ministry of Finance (Tria) and a clear commitment to Italy's continued membership of the EMU alleviated some of the most pressing concerns. With spreads at levels last seen in 2013 (vs. Bunds) or even 2011 (vs. SPGBs), Italian bonds attracted some buying once primary market conditions stabilised. Furthermore, although the appetite for large buying programmes is lacking, domestic investors do not intend to reduce their exposure, as far as we can tell.

Despite the welcome stabilisation in BTP spreads, **we still urge caution and an underweight position** on the part of EGB-benchmarked investors. The stricter border policies and early economic policy measures adopted by the 5-Star + League government are quite popular, judging by the **10-point rise in aggregate poll figures** since the March elections. This suggests that **further items on the governing 'contract' are likely to be implemented**. After the **significant roll-back of labour market liberalisation**, we can expect similar amendments to pension age legislation, income tax levels and collection, etc. Despite Tria's reassurances, other **influential politicians are openly calling for a more expansionary fiscal policy stance**.

Relatively small changes in Italy's ratings or risk/VaR profile could have adverse consequences, too. Already, LCH has raised the margin required on BTP repo transactions. On 31 August, **Fitch is due to review Italy's rating**. They said, back in March, that the new political landscape "…increased the likelihood of some fiscal loosening and further weakened the prospects for structural economic reform". Recent events tend to support that view.

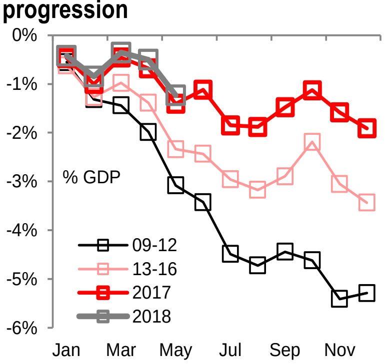
We think SPGB spreads offer good risk-adjusted value

Chart 31: SPGB-Bund spread vs. direction



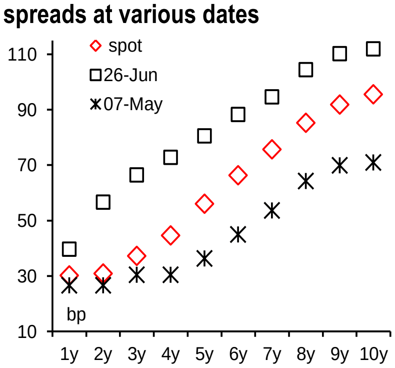
Source: Bloomberg, Santander

Chart 32: Spanish CG deficit progression



Source: IGAE, Santander

Chart 33: Interpolated SPGB-Bund spreads at various dates



Source: Bloomberg, Santander

Spanish spreads over Bunds have mirrored, in significantly reduced form, the volatile price of BTPs. The current 10y CMT spread, near 95bp, is roughly back to the level at the start of this year, but it is worth noting that it had hit lows just above 60bp and peaked in May above 130bp. This induced volatility does seem to have curtailed demand for **SPGBs to some extent. However, it bears repeating that SPGBs remain quite well behaved in risk/return terms**:

- SPGB-Bund spread **volatility remains much closer to levels seen in semi-core issuers** like Ireland and Belgium, than Italy.
- As a result of moderate volatility and still decent pick-up, SPGBs have delivered the best risk-adjusted returns (**Sharpe ratio**) among the larger EMU issuers since the beginning of 2018 (though not, evidently, since May).
- Just as importantly, **Spain spreads remain inversely related to outright Bund yields**, making Spain a positive-carry defensive allocation for EGB-benchmarked investors.

The underlying fundamental picture for Spain is quite robust. Nominal and real **GDP growth**, as well as employment growth, are at **above-EMU-average levels**. Partly as a consequence of that performance, fiscal balances remain on an improving path, in the year-to-May.

Of course, the recent switch in the executive branch of government from the PP to PSOE entails some change in policy focus. On the fiscal front, the new cabinet has made a number of announcements. Taxes, specifically on technology and financial corporations, are meant to rise by about 0.6% of GDP. There is also the **proposal to raise the spending ceiling** by a similar amount, with roughly 0.2% going to the autonomous communities and 0.3% for social spending [1].

Such statements should not generate undue concern among investors. First of all, the **magnitude is quite modest**. Secondly, given the number of seats that it has in Parliament, it is not clear that the PSOE can pass any fiscal legislation without external support. The PP's new leader (Casado) has already ruled out supporting an expanded 2019 budget, for instance. Given such benign fundamentals and relatively low debt levels, in our opinion **Spain remains on a trajectory for further rating upgrades and EGB-benchmarked investors should overweight SPGBs**.

In terms of specific areas of value, we had recommended in the past SPGB€i as well as 5y SPGB. Both positions have improved of late, especially in the 5y nominal area where SPGB spreads have recently outperformed other curve buckets, when measured against both Bunds and BTPs. We would therefore **switch the nominal spread trade to the 10y maturity** bucket.

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

Buy: SPGB 1.4% Jul-2028

Sell: Bund 0.25% Aug-2028

The spread is 95bp and we target 70bp. The carry is positive at ¾ bp per month.

[1] Economy Minister Calviño said that the 2018 and 2019 deficit figures would be about 0.5% of GDP higher than in the current national budget figures. Note, however, that this merely brings the Spanish figures more in line with EC and IMF projections. The implications for extra SPGB and regional supply, over 2018, are quite modest, in the order of single-digit bn.

Stuart Green
(+44) 0 207 7756-6170

- **The publication of the government's Brexit white paper has typically been viewed as providing further 'proof' of a shift to a soft Brexit…**
- **…but we consider several aspects of the paper to be contradictory in nature, and remain concerned by the lack of detailed plans for services**
- **Further progress on the Northern Ireland backstop is now essential**

Brexit white paper – Wishful thinking on a soft Brexit.

Although media reports suggested that the 12 July release of the UK government's Brexit white paper provided further 'proof' of a shift to a soft Brexit scenario, we regard the contents of the document as being out of kilter with the UK economy's services sector dominance. We see the proposals relating to rules of origin as essentially contradictory in nature, while the acknowledgement of a lack of formal influence upon the contents of the 'common' rulebook will also be of significance for the domestic political landscape. Indeed, until an agreement is achieved on the Northern Ireland backstop, the UK's orderly withdrawal from the EU – and the implementation of the transition period – cannot be viewed as a given.

More detail, but key questions remain

The UK government's Brexit white paper, offering the most detailed vision to date of the UK's preferred long-term relationship with the EU, sprang few surprises upon release, but was typically interpreted as offering further evidence of Prime Minister May's intention to move towards a 'soft Brexit' scenario. However, given both the focus of the white paper – offering far more detail on the future arrangements for the trade in goods than for services – and the likely opposition of the EU to several key areas of the UK government's proposals, we would strongly dispute any suggestion that a soft Brexit outcome is now assured, and that a smooth process of transition will play out. Although the initial market reaction to the white paper proved muted, we believe that volatility could well increase as the EU begins to respond to the UK's proposals in the coming weeks.

Several elements of the white paper are likely to prove of key interest from the perspective of the EU's likely negotiating position, as well as the UK political environment. Again, the central element of the UK's plans – the proposed facilitated customs arrangement – sees the UK intending to both collect EU tariffs and enforce EU product standards for any goods initially entering the UK (from a third country) en route to the EU. In effect, the prospects of the type of frictionless trade envisaged by Theresa May continue to depend on the willingness of the EU to effectively delegate its customs enforcement to a non-member country.

Rules of origin proposals fail to acknowledge trade policy trade-offs…

Importantly, the white paper proposes that UK-EU goods trade should not be the subject of routine rules of origin requirements, an issue of key importance for groups such as the auto industry. Interestingly, when future free trade agreements are secured with third countries, the UK is also advocating a position where the components or materials of a UK-produced good originally imported from the EU continue to be classified as local (i.e. UK) content from a rules of origin perspective.

However, we regard such proposals as incompatible with the operation of an independent trade policy by the UK. As differences in UK/EU tariffs (vis-à-vis third countries) emerge over time, rules of origin requirements would become necessary regardless of any adherence to a common product rulebook, but this prospect is not acknowledged by the white paper.

…and the UK still wants a voice, if not a vote, on product rules

Furthermore, on the issue of product standards, the UK is seeking input into the EU technical committees determining new product rules, whilst recognising that the UK will have no formal voting rights when the legislation formalising changes in product regulation is considered. In fact, as we have previously highlighted, non-EU EEA countries already make such contributions to technical committees, and so the white paper offers nothing new or bespoke from a UK perspective on this key issue. But, importantly, this explicit recognition of a lack of voting rights in deciding changes to the common product rulebook will again be of consequence from a domestic political standpoint.

Services detail remains scant…

The more controversial aspects of the white paper, however, still relate to the comparative lack of detail provided on the future trading arrangements governing the services sector more generally, and financial services in particular. As we have previously argued, the broad tone of the services sector-related passages of the 6 July Chequers declaration appeared contradictory in nature, given the stated intention to allow for greater autonomy to develop around UK services regulation, whilst simultaneously relying upon regulatory equivalence to maintain access to the EU's financial services markets.

…with equivalence decisions remaining an autonomous matter…

The white paper offers little detail on how this apparent contradiction may be resolved. The UK's headline ambitions for the services sector appear to relate to fairly 'standard' non-discrimination conditions, as well as the establishment of a mutual recognition framework for professional qualifications. But the proposed new economic and regulatory arrangement with the EU in financial services – to be supported by bilateral treaties - still concedes that future determinations of equivalence would be an autonomous matter for each party, even if the decisions taken are implemented in line with agreed processes. Indeed, the proposals relating to financial services appear to be more focussed upon strengthening the transparency of equivalence decisions, and extending the timeframe over which any changes in market access would occur – to include an initial consultation period should equivalence be withdrawn – than on seriously challenging the unilateral nature of the decisions taken.

…and the UK's immigration policy seemingly a work in progress

Meanwhile, where the Chequers declaration called for a common rulebook to be established on state aid, the white paper leaves matters of taxation outside of any such agreement, an omission which is sure to raise concerns on the EU side of the negotiating table. Furthermore, details on one key area of the Brexit negotiations, and a definite 'red line' for the UK government – immigration – were conspicuous by their absence from the white paper.

Once again, an enhanced mobility scheme between the UK and EU has been suggested once freedom of movement ends. But, outside of vague promises to support business activity and secure visa-free travel for tourism, no additional insight was provided on how this mobility scheme may operate. Intriguingly, the white paper promises that further details on immigration will be forthcoming once a report from the Migration Advisory Committee is published in September. Its contents could yet prove a contentious issue both for the progression of UK-EU negotiations, and the internal politics of the UK cabinet.

A basis for negotiation, with key questions unanswered

Overall, therefore, we believe that the white paper will serve as a basis for an enhanced pace of negotiation to occur between the UK and EU, whilst still leaving key questions on the UK government's Brexit blueprint unanswered. We regard the proposals relating to rules of origin as essentially contradictory in nature, while the lack of detail on services trade is likely to be the source of both frustration and disappointment across the real economy. The EU may still view the UK's proposals as challenging the indivisible nature of the four freedoms. Importantly, while the UK government may argue that the proposed trading framework would remove the need for a Northern Ireland backstop to be implemented, the need to agree upon the detail of this fallback scenario remains pressing. Indeed, until an agreement is achieved on this particularly thorny issue, the UK's orderly withdrawal from the EU – and the implementation of the transition period – cannot be viewed as a given.

UK Rates Strategy: Not so fast, Sonia!

Adam Dent
(+44) 33 114 80240

- **The market has made its collective mind up that the BoE will almost certainly hike Bank Rate on 2 August.**
- **This means short-term receiving positions face nearly one-way risks.**
- **MPC members have been extremely tight-lipped recently, and we believe their silence does not necessarily mean agreement.**
- **The UK's economic and political situation remains finely balanced.**
- **We believe the MPC will decide that the time is still not right to tighten monetary policy, while being keen to keep upcoming meetings in play**

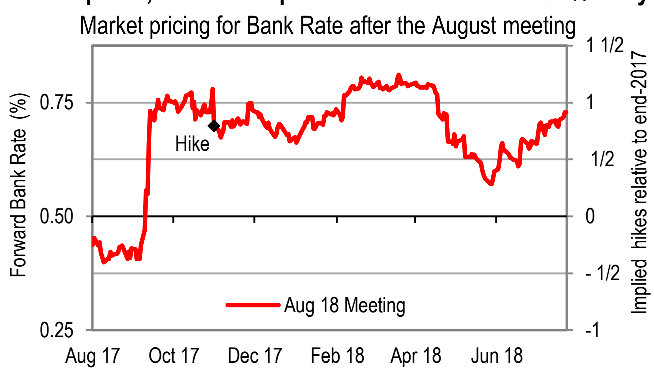
Trade idea: **Receive 6m (spot) Sonia OIS**

The fixed rate is 0.692% at the time of writing. We would hold this position through the 2 August MPC meeting, anticipating at least a 10bp rally in the event of no hike but less than 5bp risk in the opposite direction, and then reassess the trade in the light of the MPC messages and market reaction.

Exploit the very asymmetric risk/reward around markets' (premature) conviction of a Bank Rate hike next week

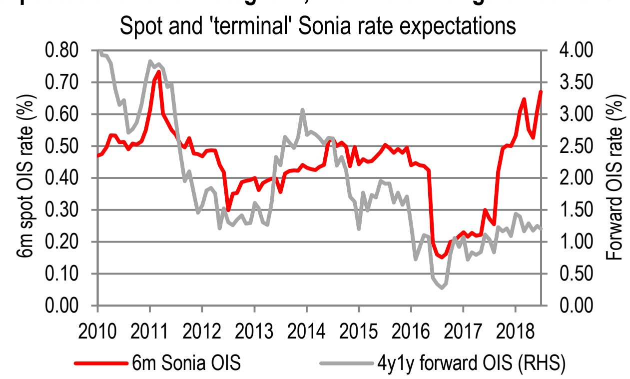
In most aspects of the UK rates market, price action over the last month has had a decidedly summery feel, with some choppy sessions but no durable trends. The main exception to that stability is the very front end, where pricing for a Bank Rate hike on 2 August has been creeping higher ever since the Italy-driven rally of late May (Chart 34). The downside surprises in both the May and June UK inflation releases did almost nothing to disturb that trend.

Chart 34: Pricing for an imminent rate hike has been building steadily since the end of May, with no lasting impact from the low CPI prints, and now implies a hike as more than 90% likely



Source: Bloomberg, ICAP, Santander.

Chart 35: Short-run rates are at their highest since early 2011 (last time there were 3 MPC votes for a hike) but medium-term expectations remain stagnant, within their range since 2016



Source: Bloomberg, Santander.

MPC members Tenreyro and Broadbent gave an interview and speech, respectively, in recent days. Neither of them offered any clues as to their thoughts on the need for or timing of rate hikes, and refused to do so when asked, which the market took as implicit validation of the rising odds. We caution that this reading may be incorrect, as the MPC has indicated its intention to wean the market off the kind of firm guidance ahead of decisions that was given in September and April.

This has taken UK near-term rates to their highest since early 2011, the last time the Committee included three consistently hawkish dissenters. Longer-term rates have remained much more sedate, and well below even their

2015 levels (Chart 35). The market seems very much aware of economic challenges such as adjusting to Brexit, secular stagnation, trade wars, etc. when evaluating likely terminal rates for this putative tightening cycle, and yet able to look through them to hold such a hawkish view on the immediate decision.

The 1y Sonia OIS rate is now 75bp, 30bp above the stable overnight Sonia fixings since the methodological reforms of 23 April (holding within 44.9-45.8bp, aside from a 1bp dip over quarter-end). That must equate to an immediate hike plus a decent chance of a second within the next year. Keeping the reasoning simple, that would correspond to a (certain) hike next week and a one-in-three chance of another as soon as February 2019. In reality, the implicit odds of a two-hike outcome are even higher than that, as they must also offset some possibility that the MPC will not hike immediately.

6m OIS, just above 0.68%, is therefore within 3bp of 'fair value' if an August hike is delivered, so receiving that fixed rate here is effectively a one-way bet. We prefer this tighter timeframe to 1y+, as it leaves very little room for any tail risks that could clear the way for aggressive tightening to crystallise (such as a breakthrough in the Brexit negotiations or clear reacceleration of global growth). Even if the MPC were merely to hesitate with a 'hawkish hold' before proceeding to hike in November, we estimate that this translates into a fair value 6m OIS of 0.58% and hence a potential 10bp windfall.

We have previously suggested trades such as 2s5s steepeners to play for a dovish reappraisal of short-run monetary policy while attempting to hedge direct exposure to the MPC's decisions. We do not consider such more subtle approaches as attractive this time:

- The clear and extreme implications of the front 6-18 month pricing fades further out, diluting the opportunity and increasing the tail risks.
- We agree with the broad picture that macro headwinds are likely to keep terminal / neutral rates low in the UK for a long time yet.
- The MPC's recent messages on potential Quantitative Tapering (QT) in the UK increase the barrier for short rates to be seen as breaching 1.5% (see the GBP Rates section of last month's I&E)
- The market 2s-5s relationship has now clearly established a new regime, and it would likely take major new macroeconomic and/or political developments to shift the regime back to that seen in 2015.
- We find it very hard to say what the curve's reaction would be even if we knew for certain whether the MPC will hike or hold: so much would depend on the tone of the minutes, Inflation Report and press conference, which could either reinforce the market's current inclination towards 'one-and-done' or stress the MPC's intention to deliver a gradual but meaningful cycle.

Risk/reward aside, the fundamentals argue against a hike

We still believe that the most likely outcome is that Bank Rate will not be raised at this meeting, or indeed at all over the next couple of years. We have explored the details of the UK's fragile situation in several economics notes recently. Here is an extremely abbreviated summary of their findings:

- **Inflation:** Unexpected weakness in several core components outweighed the upward contribution from fuel and utilities in June, which we regarded as further evidence that underlying, domestically-generated inflationary pressures are insufficient to keep inflation at (let alone above) target once currency and energy shocks abate (Inflation inertia another reason to hold firm, 18 July).

- **Wages:** We are unconvinced by the BoE's long-held, and long-disappointed, assertion that a tight labour market is about to deliver upward wage pressures, and believe that the hawks' focus on the headline unemployment rate misses some profound changes in labour market efficiency and structure (The UK Phillips curve: Missing inaction?, 16 July).

- **GDP:** The apparent "rebound" in growth between Q1 and Q2 is due to retail sales and, in turn, the dramatic improvement in weather conditions. Just as the MPC looked through February's weakness as a temporary weather distortion, the rebound should not be expected to drive further growth from here (Is the Gulf Stream now driving UK monetary policy?, 25 July).

Just taken on their own, we believe these factors have eased the growth/inflation trade-off and warrant –or at least buy time for– waiting for clearer evidence of inflationary pressures in the data before pre-empting them with tighter monetary policy. But 'normal' macro news is far from the most pivotal influence on the UK's economic outlook: as uncomfortable as it is for an apolitical institution like the BoE, Brexit must not be ignored.

The UK Economics section, above, contains a thorough update on the latest situation. The key takeaways for the MPC are that uncertainty is very high, a hard Brexit cannot be ruled out, but hard deadlines are fast approaching. Even given the BoE's requirement to treat official government policy –a smooth and predictable withdrawal and "implementation period"– as the base case, it would be very bold to tighten policy against a delicate economic backdrop based on such an assumption. The likely outcome should be much clearer by the MPC's November meeting, after the October European Council summit which is now being touted as the vital deadline.

All in all, an urgent hike does not seem justified to us. That would come as a sharp surprise to the market, but would serve as a useful reminder of the importance of markets following the fundamentals rather than waiting to be spoon-fed the path of policy in advance – a warning Governor Carney has repeatedly tried, and failed, to deliver. The near-complete lack of a rates market reaction to the (second) CPI shortfall underlined this problem, and perhaps it will take shock therapy to make the message stick. Bracing for such a shock is a potentially rewarding strategy with limited downside.

Stuart Bennett
(+44) 33114 80134

Taken from our latest FX Compass, published 26 July

USD – Who's afraid of the big, bad trade war?

The USD remains firm. A robust economy, rising inflation and interest rate hikes are providing support and should continue to favour a firm currency. However, trade tension risk and an adverse impact on global trade could eventually be viewed as a USD negative factor.

Trade tensions between the US and China continue to dominate market sentiment, with the US threatening to put a 10% tariff on all of its $500bn worth of Chinese imports. Hence, the IMF recently reiterated the warning that an 'escalating' and 'sustained' trade conflict threatened to derail economic recovery and depress medium-term growth prospects.

However, are such trade tensions a USD positive, or negative factor? At the start of 2018 they seemed dollar negative, perhaps given the perception that the catalyst for the tension seemed to stem from the US.

Although, this stance also allowed the market to continue the sell USD trade that had dominated throughout much of 2017. Since mid-April, trade jitters have tended to be more USD positive, fuelling demand for the dollar as a safe-haven and confirming the general appreciation in the currency.

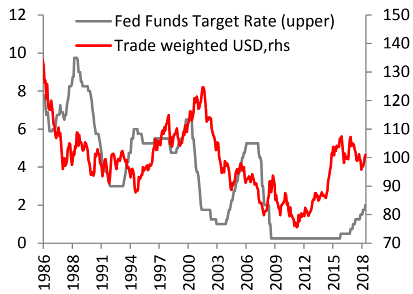
Looking forward, the impact of trade tensions on the USD, via the interest rate channel, may be ambiguous. The US economy continues to outperform. We expect US GDP growth of 2.8% in 2018 and 2.7% in 2019, compared to an albeit still respectable 2.3% and 2.2%, respectively, for the Eurozone. Hence, we forecast US headline inflation at 2.5% this year and 2.4% in 2019.

Consequently, the economic backdrop provides ample justification for the Fed to continue hiking US rates, both this year and next. However, with inflation high, there is a risk that tariffs on US imports could pull inflation higher, whilst not dampening growth too much, and force the Fed into a more hawkish stance, driving up the USD. Whilst not impossible, the market does not assign a high probability to this outcome. Hence, we still expect the Fed to hike rates by a total of 50bp in H2-18 and another 50bp in 2019.

Indeed, we see USD risks to the downside if, as the IMF fears, the trade war escalates and threatens world growth, which by extension would also undermine US growth. Admittedly, the US would probably still be outperforming its developed market peers and providing some support for the USD from activity, but the threat would be that the market would start to price out the US rate hikes that it expects over the coming months.

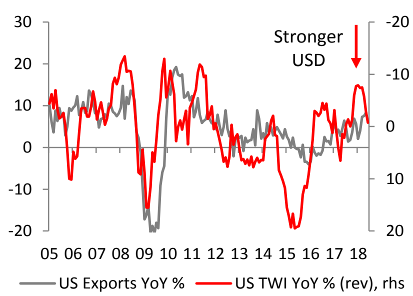
Certainly, global growth worries may also weigh on other currencies as perhaps their central banks adopt a more dovish stance. However, less is priced in for the others and many are already adopting very cautious stances, e.g. the BoJ and SNB are unlikely to alter their loose policy until late 2019, the ECB says it will not hike rates until Q3-19 and we do not think the BoE will hike either. Hence, it appears that it is the USD that has the most to lose from a trade-inspired global slowdown that forces policymakers to cling to accommodating monetary policy.

Chart 36: US rates going up, but has that been priced in by the USD



Source: Bloomberg, Santander

Chart 37: We continue to suspect that a strong USD does not fit well alongside protectionist policies

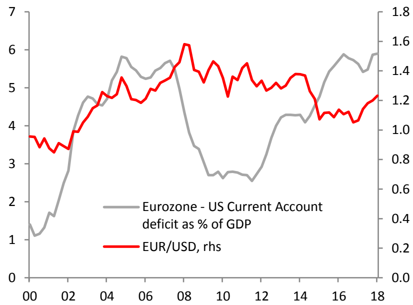


Source: Bloomberg, Santander.

EUR – A gradual and steady advance

We still expect a steady, but gradual, appreciation in EUR/USD. Given that trade tensions are viewed, at least for now, as USD positive, a ratcheting up of these threats over the coming month will pose a risk to the EUR. In addition, the prospect of more US rate hikes in 2018 should offer support, but these and the positive US economic outlook should now be priced in, whilst we feel that the market adopted too pessimistic a stance towards the EUR, which will have scope to unwind.

Chart 38: Eurozone current account performance versus the US – a EUR/USD positive, or at risk from trade tensions?



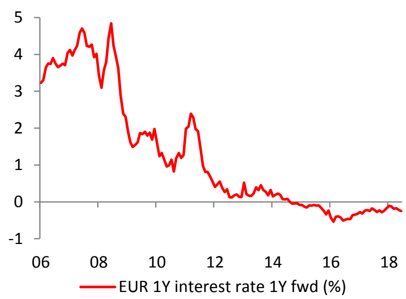
Source: Bloomberg, Santander

Recall that at its June meeting, the ECB confirmed that its asset purchase programme would be reduced from €30bn to €15bn per month in Q4-18, and ended completely at the end of this year. The end to QE and the printing of money should, in our opinion, have been EUR positive. However, Draghi also indicated that interest rates would likely remain at the current level (depo rate at -0.4%) through the summer of 2019.

The prospect of rates being kept extremely low for longer than expected caught the market off guard, and weakened the EUR. However, over the past month EUR sentiment has been steadily improving, helped by a softer USD. The ECB rhetoric suggests to us that the Bank is still unwilling to let rate hike expectations pull the EUR higher too quickly. However, the 'no rate hike until Q3-19' probably represents the most dovish stance that is now left available to the Bank. Hence, the policy risks for the EUR may now be skewed to the upside, if firm economic data indicate that a rate move could be made before Q3-19.

The Eurozone economic outlook does not paint a picture of an economy that is so vulnerable that it will require negative interest rates for another 14 months. The ECB staff forecasts did include a downward revision to 2018 GDP, to 2.1%, but inflation in 2018 was revised up to 1.7% YoY from 1.4%. Note that inflation in June CPI was 2% YoY, effectively above the ECB's target. Indeed, a Reuters report on 11 July indicated that the ECB was split on the timing of a rate increase, with some members favouring July 2019.

Chart 39: The only way is up? – for interest rates and the EUR



Source: Bloomberg, Santander

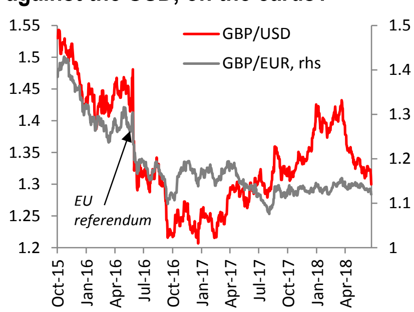
An obvious threat to our forecast for gradual appreciation is still global trade tensions. The market, for now still seems willing to see such tensions as USD positive, and by default EUR negative. But, are they? Given that the Eurozone has a current account surplus, a threat to global demand might undermine that and reduce inflows to the region. But, if the focus remains on US-China trade relations, a more regional conflict might weigh more on the USD and Yen, reducing their attractiveness as safe-haven currencies, with, perhaps, the EUR picking up that safety-related demand.

The IMF has warned that a global trade war threatens global growth. Given the ECB's current stance on rates, there may be less room for them to adopt an even more dovish stance. Instead, the risk might be that the global concerns force the Fed to think twice about the US rate hikes that the market has priced. Such a repositioning should be EUR/USD positive.

Elsewhere, Euro-specific risks, focussing on Italian and German politics, have faded, and speculators maintain a small net long EUR/USD position. Plus, even if Brexit uncertainty acts as a brake on EUR gains, it should have more of an impact on Sterling, implying EUR/GBP still edging towards 0.9200 by year-end.

GBP – Uncertainty rules UK, again

Chart 40: Here we go again. Is another uncertainty driven move lower, at least against the USD, on the cards?



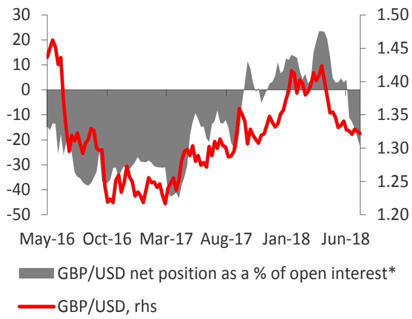
Source: Bloomberg, Santander. Note: Weekly data

The Pound looks set to remain under pressure over the coming month. A firm USD is helping hold down GBP/USD, and with the Eurozone economy set to outperform the UK's, we still see EUR/GBP risks as skewed to the upside. We continue to believe the BoE will not hike rates in August, and Brexit uncertainty should temper investor demand to buy the Pound.

Sterling has been the worst performing developed market currency over the last three months, although this has not been due solely to GBP-specific factors. Since the market turned USD bullish in mid-April, the Pound has weakened by around 9.5% against the Greenback. To put that into perspective, in the three months following the EU referendum in June 2016, GBP/USD dropped around 18%.

Will Sterling fall further? We are maintaining our forecasts that envisage GBP/USD hovering around 1.32 through to the end of the year, but concede that the Pound's recent decline suggests that the risks are skewed to the downside. However, we reiterate that support for the currency should, ironically, stem from its reaction to the referendum. The decline in the Pound was oversized, and we would suggest should be viewed as already pricing in most of the 'uncertain' developments in news, politics and the economy that the market has recently been faced with.

Chart 41: Speculators have been building net-short GBP/USD positions



*Open interest=total long and short contracts

Source: CFTC, Bloomberg, Santander

Hence, further weakness should be viewed as an undershooting in the currency. Usually, we would argue such a move should be viewed as an opportunity to buy the currency, under the assumption that it will reverse and rally. However, several factors suggest that at best Sterling will remain soft.

First, the economy is still expected to underperform its peers. Admittedly, UK economic data has started to surprise to the upside, but overall we forecast GDP growth of just 1.2% this year, compared to 2.8% for the US and 2.3% for the Eurozone.

Second, we do not expect the BoE to hike rates at its August meeting. Indeed, we expect UK rates to remain on hold for some time. The June CPI data was weaker than expected, unchanged at 2.4% YoY. The market responded by cutting the chances of an August move.

Third, political/Brexit uncertainty should remain a market focus. The government managed to get a majority in the UK Parliament to agree to its 'Brexit Plan'. However, the votes were very close, there is doubt as to whether the EU can agree to the proposals, and after the resignation of both the Foreign Secretary and Brexit Secretary, speculation has mounted that the PM may eventually face a vote of no-confidence, which might in turn be followed by another general election.

Thus, uncertainty continues to weigh on the Pound. Hence, fast money accounts have, perhaps unsurprisingly, added to their short GBP positions. The IMM non-commercial position data as of mid-July show that the net short GBP/USD position was at its highest since mid-September 2017. However, it is less than half the size of the record net short position, recorded in March 2017, suggesting that if uncertainty remains there is ample room for positioning to move further against the Pound.

Table 6: G10 FX forecasts

	Q3-18	Q4-18	Q1-19	Q2-19	Q3-19	Q4-19
EUR-USD	1.19	1.21	1.23	1.24	1.25	1.26
GBP-USD	1.32	1.32	1.32	1.33	1.35	1.36
GBP-EUR	1.11	1.09	1.07	1.07	1.08	1.08
EUR-GBP	0.90	0.92	0.93	0.93	0.93	0.93
USD-JPY	117	118	120	120	120	118
EUR-JPY	139	143	148	149	150	149
USD-CNY	6.65	6.70	6.80	6.70	6.70	6.70
EUR-CHF	1.18	1.20	1.22	1.23	1.24	1.24
USD-CHF	0.99	0.99	0.99	0.99	0.99	0.98
EUR-SEK	10.2	9.9	9.7	9.5	9.3	9.2
EUR-NOK	9.4	9.3	9.1	9.0	8.8	8.7
USD-CAD	1.24	1.22	1.22	1.20	1.20	1.19
AUD-USD	0.76	0.77	0.79	0.80	0.79	0.78
NZD-USD	0.71	0.72	0.74	0.76	0.75	0.75

Source: Santander

Euro interest rate forecasts

Government Bond yield Forecasts

Bunds	Current	3Q18	4Q18	1Q19	2Q19	3Q19	4Q19
ECB Refi	0.00	0.00	0.00	0.00	0.00	0.30	0.50
ECB Depo	-0.40	-0.40	-0.40	-0.40	-0.40	-0.20	0.00
3m	-0.57	-0.65	-0.60	-0.55	-0.40	-0.20	0.00
2y	-0.60	-0.45	-0.30	-0.15	0.00	0.25	0.45
5y	-0.16	0.05	0.25	0.50	0.65	0.85	1.00
10y	0.41	0.55	0.75	1.00	1.25	1.40	1.55
30y	1.06	1.10	1.25	1.50	1.70	1.90	2.05

Swap rate forecasts

€ swaps	Current	3Q18	4Q18	1Q19	2Q19	3Q19	4Q19
ECB Refi	0.00	0.00	0.00	0.00	0.00	0.30	0.50
ECB Depo	-0.40	-0.40	-0.40	-0.40	-0.40	-0.20	0.00
3m	-0.32	-0.33	-0.33	-0.28	-0.17	-0.01	0.22
2y	-0.15	0.00	0.10	0.20	0.30	0.55	0.75
5y	0.31	0.50	0.70	0.85	1.00	1.20	1.35
10y	0.92	1.00	1.15	1.35	1.60	1.75	1.90
30y	1.51	1.45	1.55	1.75	1.95	2.15	2.30

US interest rate forecasts

Government Bond yield Forecasts

USTs	Current	3Q18	4Q18	1Q19	2Q19	3Q19	4Q19
FOMC (mid)	1.875	2.125	2.375	2.625	2.875	2.875	2.875
3m	1.98	2.15	2.40	2.65	2.90	3.00	3.10
2y	2.67	2.80	3.05	3.25	3.40	3.50	3.60
5y	2.85	2.95	3.20	3.45	3.60	3.65	3.70
10y	2.97	3.05	3.25	3.45	3.60	3.70	3.80
30y	3.09	3.15	3.30	3.45	3.55	3.60	3.65

Swap rate forecasts

$ swaps	Current	3Q18	4Q18	1Q19	2Q19	3Q19	4Q19
FOMC (mid)	1.875	2.125	2.375	2.625	2.875	2.875	2.875
3m	2.34	2.55	2.75	2.95	3.15	3.20	3.25
2y	2.87	3.05	3.25	3.40	3.50	3.55	3.60
5y	2.97	3.05	3.25	3.45	3.55	3.55	3.60
10y	3.02	3.05	3.20	3.40	3.50	3.60	3.70
30y	3.02	3.05	3.20	3.35	3.40	3.45	3.50

UK Interest rate forecasts

Government Bond yield Forecasts

Gilts	Current	3Q18	4Q18	1Q19	2Q19	3Q19	4Q19
MPC	0.50	0.50	0.50	0.50	0.50	0.50	0.50
3m	0.75	0.45	0.40	0.45	0.45	0.46	0.48
2y	0.76	0.40	0.50	0.50	0.55	0.60	0.75
5y	1.02	0.75	0.90	1.00	1.20	1.50	1.60
10y	1.28	1.20	1.40	1.60	1.80	1.90	2.00
30y	1.73	1.70	1.80	2.00	2.20	2.40	2.50

Swap rate forecasts

£ swaps	Current	3Q18	4Q18	1Q19	2Q19	3Q19	4Q19
MPC	0.50	0.50	0.50	0.50	0.50	0.50	0.50
3m	0.80	0.65	0.55	0.55	0.55	0.56	0.58
2y	1.10	0.70	0.95	0.95	0.95	0.90	1.05
5y	1.34	1.05	1.25	1.30	1.45	1.70	1.80
10y	1.54	1.40	1.60	1.70	1.90	1.95	2.05
30y	1.62	1.50	1.40	1.65	2.00	2.10	2.20

FX forecasts

	Current	3Q18	4Q18	1Q19	2Q19	3Q19	4Q19
EUR-USD	1.163	1.19	1.21	1.23	1.24	1.25	1.26
EUR-GBP	0.888	0.90	0.92	0.93	0.93	0.93	0.93
GBP-USD	1.309	1.32	1.32	1.32	1.33	1.35	1.36
USD-JPY	111.2	117	118	120	120	120	118
EUR-JPY	129.3	139	143	147.6	148.8	150	149

	Current	3Q18	4Q18	1Q19	2Q19	3Q19	4Q19
NZD-USD	0.68	0.7	0.7	0.7	0.8	0.8	0.8
USD-CAD	1.307	1.24	1.22	1.22	1.20	1.20	1.19
AUD-USD	0.74	0.8	0.8	0.8	0.8	0.8	0.8
EUR-CHF	1.159	1.18	1.20	1.22	1.23	1.24	1.24
EUR-SEK	10.31	10.2	9.9	9.7	9.5	9.3	9.2
EUR-NOK	9.55	9.4	9.3	9.1	9.0	8.8	8.7

IMPORTANT DISCLOSURES

ANALYST CERTIFICATION:

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

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

G-10 Rates, Macro & FX Strategy

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

EXPLANATION OF THE RECOMMENDATION SYSTEM

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

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

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

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

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

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

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

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

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

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

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

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

ADDITIONAL INFORMATION

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

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

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

COUNTRY & REGION SPECIFIC DISCLOSURES

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

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

Local Offices

Madrid	**Lisbon**	**London**	**Milan**
Tel: 34-91-257-2035	Tel: 351-21-389-3400	Tel: 44-870-607-6000	Tel: 39-02-8542-09810
Fax: 34-91-257-0252	Fax: 351-21-387 0175	Fax: 44-20-7332-6909	Fax: 39-02-8606-71648
Brussels	**Paris**	**Frankfurt**	**Caracas**
Tel: 32 2 286 5447	Tel: 33 15353 7000	Tel: 49 6959 67-6403	Tel: 582-401-4306
Fax: 32 2 230 6724	Fax: 33 15353 7060	Fax: 49 6959 67-6407	Fax: 582-401-4219
New York	**Bogota**	**Buenos Aires**	**São Paulo**
Tel: 212-756-9160	Tel: 571-644-8008	Tel: 54114-341-1052	Tel: 5511-3012-5721
Fax: 212-407-4540	Fax: 571-592-0638	Fax: 54114-341-1226	Fax: 5511-3012-7368
Lima	**Mexico DF**	**Santiago de Chile**	
Tel: 511-215-8133	Tel: 525-629-5040	Tel: 562-336-3300	
Fax: 511-215-8161	Fax: 525-629-5846	Fax: 562-697-3869	