04 June 2018, 15:00 CET

Interest & Exchange

Geopolitics vs. Macro Fundamentals

Global Strategy: Despite the massive increase in volatility in global financial markets following recent events in Italy - and to a lesser extent Spain -, barring further risk-off episodes severely affecting investors or consumers' confidence, we don't believe these events will affect the ECB's planned start of its gradual normalization process, in either conventional or non-conventional monetary policy.

Economic Outlook: We believe that better fundamentals should enable the Euro zone economy to run its race in 2018-19E at a GDP 'speed' of over 2.0%. We have raised our GDP estimate for the US for 2018 to 2.8% (2.5% previously) and for 2019 to 2.7% (2.6% previously), after taking into account the approved measures of President Trump's fiscal reform.

US Rates: We expect the US rates market to remain driven by risk aversion flows and, therefore, directionality will be determined by the developments in the Eurozone. But for the time being, we see no reasons to change our medium-term call. We cling on our open trades and now suggest going long inflation through 2y breakevens, taking advantage of what we consider a dislocation.

EUR Rates: EUR rates markets have recently been driven by Italian political and economic policy uncertainty. With a new government being formed, the market should enter a less agitated, transitional phase during which spreads and levels that moved largely on the back of the risk-off momentum should correct back.

GBP Macro: Expectations around the near-term path of UK monetary policy have proved fluid in recent weeks, with the implied probability of an August rate hike falling from c95% in mid-April to just 30% currently. We continue to forecast an unchanged monetary policy stance through both 2018 and 2019. But with market pricing still suggesting that a 2018 rate hike is more likely than not, a residual and durable hawkishness would still appear to exist across UK markets. We expect this hawkish sentiment to fade in the coming weeks, as weak activity and inflation data combine with continued Brexit uncertainty.

GBP Rates: Late May's risk-off stampede proved that gilts are still seen as a 'safe haven', but markets are now back to paying great attention to political risks - which could prove acute in the UK as Brexit rows come to a head this summer. We consider opportunities for a protracted risk-off spell in UK rates, and favour broad (5s30s) steepeners, either on the yield curve or as an ASW box. Long gilts' run of strength will be hard to extend further, whereas 5y has cheapened this year.

G-10 FX: The USD has strengthened over the last month. The currency looks to have recoupled with fundamentals and monetary policy/interest rate spreads. But after strong gains, the currency may now find it harder to move even higher in the short term. The EUR has been under pressure. We suspect that it may be drifting into oversold territory and retain our forecast profile that envisages gradual gains in H2-18 and 2019. Sterling has performed poorly since mid-April. We still see some downside pressure in GBP/USD and maintain our year end forecast for GBP/USD at 1.32.

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

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

	USD	EUR	GBP
Economic Outlook	We have revised our GDP estimates for 2018E to 2.8% YoY (vs 2.5% before) and to 2.7% in 2019E (vs 2.6%) after including the effect of the fiscal reform in the US. We forecast a higher fiscal deficit and a worsening of the current account positon.	We have slightly reduced our GDP estimate for 2018E to 2.3% (vs 2.4% previously), while leaving 2019E at 2.2%. Growth in 1Q18 was lower than-expected but fundamentals support 2.0%-plus GDP growth rates in 2018E-19E 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 help real consumption growth recover in 2H18E.
Monetary Policy / Front-End	We maintain our long-held call of three 25bp hikes from the Fed in 2018E, with an eye on core inflation, wages and DXY. Upside risk.	We expect the ECB to continue buying bonds (€30bn/mth) until Sep'18E, followed by a small tapering in 4Q18E, with the first rate hike around mid-2019E. Watch the EUR.	We expect Bank Rate to remain at 0.5% through 2018E and no change in QE, with growth and inflation likely to fall short of MPC expectations.
Rates / Duration	The monetary policy normalization, healthy macro environment and potential changes in supply/demand equilibrium should weigh on USTs all along the curve.	The risk-off rally in core rates may not last, but monetary policy and underlying data do not justify a protracted sell-off yet.	Rates and pricing for a BoE hike by the end of this year still look too high, although the penny has started to drop about weak data in the UK.
Curve / Slope	We remain bearish on the front end (pay 2y2y) but continue to see further yield increases in the belly as limited. Play carry-efficient shorts (pay the belly in 2s5s10s).	Curve relationships are in a transition, especially between the intermediate and longer maturities. Up to 7-10y, higher rates remain associated with steepening.	UK curves remain unduly flat at all tenors, even after the limited re-steepening this month, and we see more risk premium as warranted.
Spreads	Gradually unwinding SOMA reinvestments pose a risk for USTs. We like swap spread wideners (bearish USTs), especially in the ultra-long end.	Italian political risk is the main driver. As we enter a more transitional phase, with less exciting news flow, SPGB (and other EGB) spreads to Bunds should shrink back.	Short gilt ASW appeal for a dovish re-pricing, the 5s10s is box still too steep, and the long end looks stretched.
Volatility	The top left corner starts to look rich, compared to recent ranges and also to delivered vol. We believe some correction is possible.	Realised volatility is slightly higher, having set new all-time lows earlier this month. Implied volatility has finally reacted but is likely to fade in June.	Long-tenor implied vols have finally started to reflect secular uncertainties, and now it is short tenors that look relatively complacent.
Inflation / Break-evens	After recent market volatility, front-end breakevens are clearly lower (as opposed to the rest of the curve) with no fundamental reasons behind. We see a buying opportunity there.	Traded inflation had priced in improved CPI figures but the May preliminary beat expectations. 15y SPGB€i looks cheap in RV.	Petrol prices will briefly pause the fall in CPI, but we still expect a move to the 2% target by year-end. Wage growth remains pivotal, and so far underwhelming.
FX	The USD has rebounded recently. Political and trade concerns may still weigh. But, the mix of a strong economy and further Fed rate hikes in 2018E 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, as well as the market pricing out near-term rate hikes.

Source: Santander Economics, Rates and FX Strategy Research. For a full list of contributors, please see contact details on page 34.

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

	USD	EUR	GBP
Govies	**Buy the 2y USTi breakeven** Entry level = 1.85%. Target level = 2%. Stop loss = 1.80%	1) **ASW SPGB 1.6% Apr-2025** at – E+36 bp. Target E+10 bp.. 2) **RASW Schatz 0% Jun-2020** at E -53p. Target E -40bp.	**Gilt 5s30s steepener (2Q 23s/46s), outright /ASW box.** Current yield spread = 77bp. Target level = 85bp. Stop loss = 36bp.
Rates	**1) Pay the belly in 2s5s10s** Entry = 3bp. Target = 10bp. SL= 0bp **2) Receive 15y vs. pay 5y5y** Entry sprd level = 7bp.Target = 30bp. Stop loss = -5bp **3) Pay 2y2y in USD swaps** Entry level = 2.90%.Target = 3.30%. Stop loss = 2.70%	**1) Pay 10y Euribor fixed , receive 10y ILS.** Current real rate at -0.7%, target -0.45%	**1) GBP 5s10s steepener.** Current level = 24bp. Target level = 34bp. Stop loss = 22bp. **2) Buy 40y gilt inflation break-even.** Current level = 315bp. Target level = 325bp. Stop loss = 313bp.
FX	**Buy USD/JPY** original entry at 109.30 target= 114, with a stop loss at 107.00	**Sell EUR/JPY** original entry at 128.25, Target = 124. SL = 131.59.	**Sell GBP/NZD** original entry at 1.9150 (Dec - 17). Target = 1.75. SL = 2.00

Global Strategy: First Match Ball Saved

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- **Despite the massive increase in volatility in global financial markets following recent events in Italy - and to a lesser extent Spain -, barring further risk-off episodes severely affecting investors or consumers' confidence, we don't believe these events will affect the ECB's planned start of its gradual normalization process, in either conventional or non-conventional monetary policy.**

An unexpected source of global market volatility

This year's major market surprise came from where almost no one was expecting. With most market participants focusing on US rates, the implications of the US Tax plan and protectionism conflicts, it was the horse trading around the formation of a new Italian government, whose elections had taken place three months before what proved to be the biggest market event so far in 2018. And surprising the market to such an extent is not an easy task, after everything we have gone through in recent years.

Although the unlikely, and potentially explosive, coalition of the two most-voted parties, LN and M5S, was considered the most likely outcome of the March Italian General election (see Table 1), it was the draft of this coalition's electoral program that sent shivers down investors' backs.

Even acknowledging that these two parties have very little in common, apart from fiscal profligacy and certain populism, this coalition's 'government agreement' seemed to be simply the sum of their two already fiscally loose programs (wish list), rather than a combined effort, hence including their electoral platforms' flagship issues: the LN's 15-20% flat tax and M5S's universal income. According to some sources, all the measures in the combined program would have a cost of c.6% of GDP, to add to the existing 1.6% current net borrowing needs.

But the spark that ignited volatility was the alleged references to a possible exit plan from EMU (in case it was eventually considered opportune) and the potential confrontations with the EC on fiscal policies. A move that fostered by the structurally poor market liquidity, took two-year BTPs to 276bp (from 26bp) in just two days (Chart 2), a move 70 times bigger than this market's average daily move.

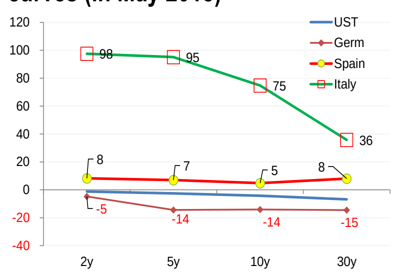
At that juncture, investors were probably reminded about the poor perception Italians have regarding how their country benefits from being a member of the EU which, according to the latest EuroBarometer, ranks the lowest within its members, even lower than the UK, Greece or Cyprus (Chart 3).

Table 1: Italian chamber of deputies March 2018 elections

	Leader	% Vote	Seats
M5S	L. Di Maio	32.7%	227
PD	M. Renzi	18.7%	112
+Europa	E. Bonino	2.6%	3
Other (3)		0.5%	7
Center Left		**21.8%**	**122**
Lega Norte	**M. Salvini**	**17.4%**	**125**
Forza Italia	S. Berlusconi	14.0%	104
Fratelli d Italia	G. Meloni	4.4%	32
Noi Con Italia	R. Fitto	1.3%	4
Center Right		**37.0%**	**265**
Liberi e Uguali	P. Grasso	3.4%	14
Other Parties			2

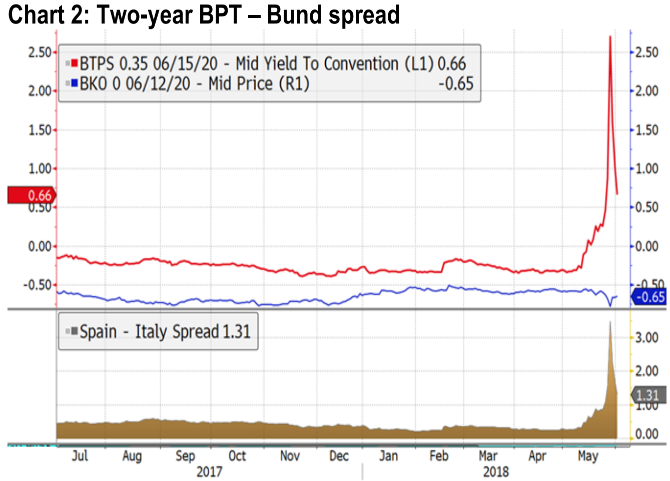
Source: Italian Parliament

Chart 1: Changes in government curves (in May 2018)



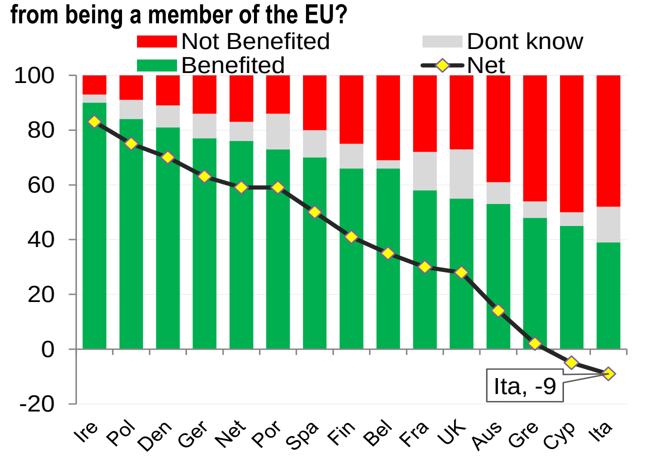
Source: Bloomberg, Santander

Chart 2: Two-year BPT – Bund spread



Source: Bloomberg, Santander

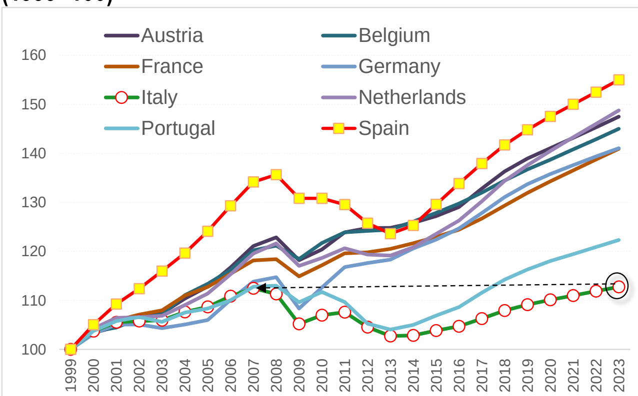
Chart 3: Would you say that your country has benefited (or not) from being a member of the EU?



Source: EuroBarometer European Parliament

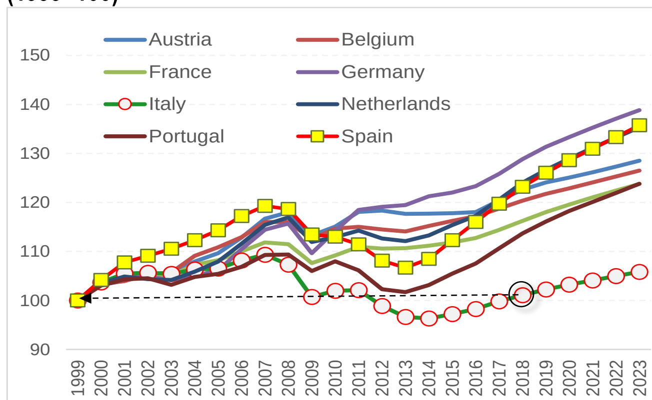
Without drilling down at this stage into the underlying reasons behind that perception, the truth is that when looking at the economic performance of this country since the EMU started, although there are very clear multiple and important advantages, it is also true that some other macro variables have underperformed expectations, or other countries' performance. Among others we would highlight the fact that, according to the IMF, Italy will not recover its pre-crisis (2007) level of real GDP until 2023, or the fact that the present GDP per capita in this country is basically at the same level it was before EMU started (Charts 4 and 5).

Chart 4: Euro area countries' GDP constant prices (1999=100)



Source: IMF, Santander

Chart 5: Euro area countries' GDP per capita, constant prices (1999=100)



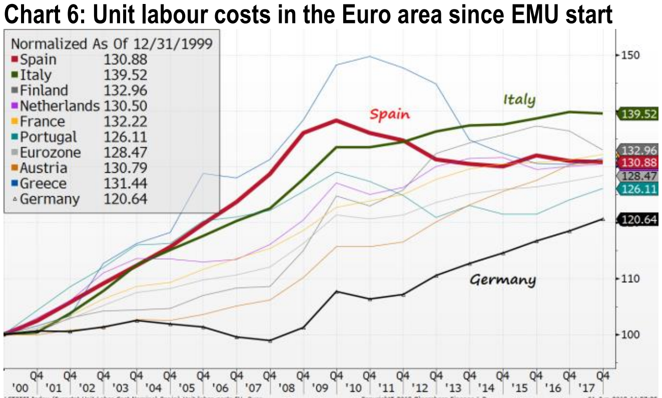
Source: IMF, Santander

Even more important in our opinion is that ULCs have increased almost relentlessly in this country since EMU started, now being 40% above its pre-euro levels, significantly above Spain's 30% cumulative growth and twice as much as Germany's 20% ULC growth in this period, showing the sizeable competiveness loss according to this metric (Chart 6).

Yet we believe the political commitment and benefits from belonging to the common currency more than offset these aspects, but some structural reforms (probably starting with the electoral system) seem necessary to avoid a complicated situation down the road, whenever the next recession comes, especially given the very high level of public debt (120 and 130% of GDP in Net and Gross terms, respectively, see Chart 7).

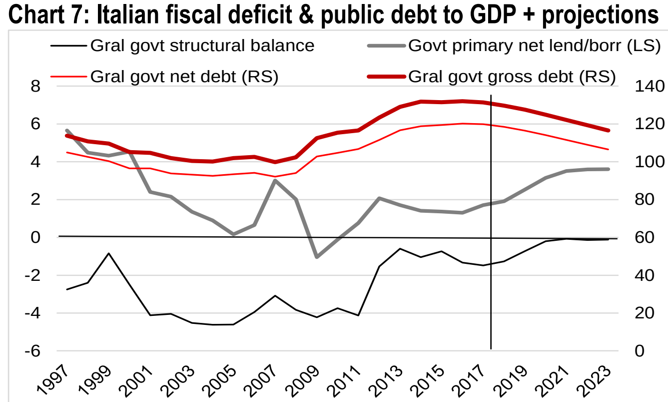
Helped by the formation of the new government and the huge global liquidity, the situation seems to be slowly recovering, although it is inevitable that some fears will take time to fade, and BTP spreads and yields are unlikely to come back to previous levels anytime soon. But besides the obvious market impact, especially in BTPs, the other key question is whether these recent events would affect the ECB's monetary policy.

Chart 6: Unit labour costs in the Euro area since EMU start



Source: Bloomberg, Santander

Chart 7: Italian fiscal deficit & public debt to GDP + projections



Source: IMF, Santander

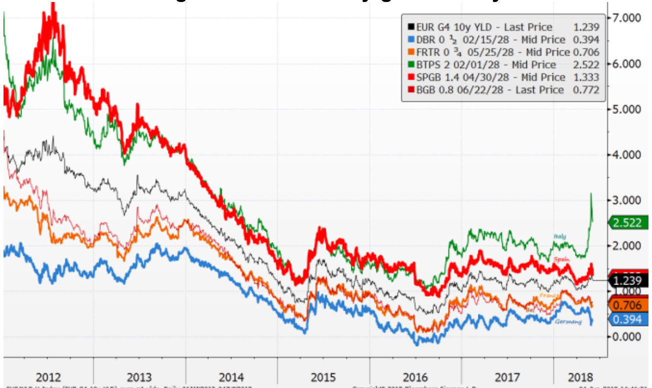
Benefit the sinner, no thanks

Regarding the ECB's non-conventional monetary policy, despite the extent of the increase in EUR rates, especially in the front-end, we think it has not gone far enough to imply real redenomination fears. Not only compared to previous episodes (see Chart 8), but also bearing in mind that, for an economy growing at c.3% in nominal terms, having ten-year government yields at 2.6%, it doesn't feel like panic.

Additionally, the ECB would not set the correct precedent if it is willing to partially isolate a country from potential investors' fears, caused by a lack of a clear commitment to respect the EC fiscal rules. Not to mention the potential loss for the remaining EMU members in the unlikely case a country decides to leave the Euro and redenominate its debt into its local currency.

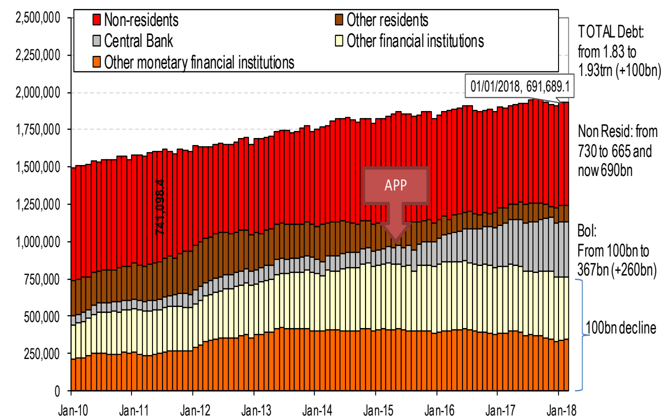
All this bearing in mind that the ECB is currently the largest holder of this debt with c.€340bn in Italian public sector assets, to add to the remaining SMP holdings. Some other types of official aid exist, should a country ask for it, but with clear conditions attached

Chart 8: Euro largest countries' 10y govt bond yields



Source: Bloomberg, Santander

Chart 9: Italian public debt by ownership



Source: Bloomberg, Santander, Italian MoF

Additionally, other aspects that the ECB should consider before extending its bond purchase program are: (i) at €2.6trn by the end of this year, the ECB will already hold a massive amount of euro government bonds in its portfolio and (ii) the potential resurfacing of scarcity concerns in German public debt in case the ECB decides to prolong its PSPP.

We therefore stick to our long held view that the ECB will continue buying €30bn per month to the end of September, to enact a tapering period in 4Q18 (€10-15bn per month), ending the EAPP by year-end.

And then, for 2019E and onwards, the ECB should simply commit to maintain its chunky portfolio for a prolonged period of time, with the reinvestment of its redemptions already having an impact on Euro government bond prices through an important duration effect. But we believe the ECB will not provide much details in this regard (end of EAPP), in the upcoming June 14 meeting.

That said, while a couple of months ago, the main risk scenario to our call (65% probability) was a potential end of the purchases already by September 2018 (we assigned a 25% probability to this possibility), with a 10% chance of a potential delay of the end of the EAPP (macro weakness, extreme Euro strength, trade war, etc.), those probabilities have now probably reversed, being currently the main risk even a potential delay of the ECB's APP, in case the political scenario deteriorates further thereby, affecting consumer and investor confidence. But we still believe the most likely scenario has not changed.

No changes in the ECB's official rates normalization path either

On the conventional monetary policy front, we also keep our call unchanged. At least regarding the initial phase. In fact, when the ECB updates its macro projections in coming weeks in the run up to the June 14 meeting, despite weaker-than-expected 1Q18 GDP number (+0.4% qoq), the extent of the negative surprises in recent macro releases and the concerns of the possible further decline in the EZ confidence and business surveys, there should be other factors more than offsetting this deterioration.

Especially on the inflation front, what we believe really matters to the ECB:

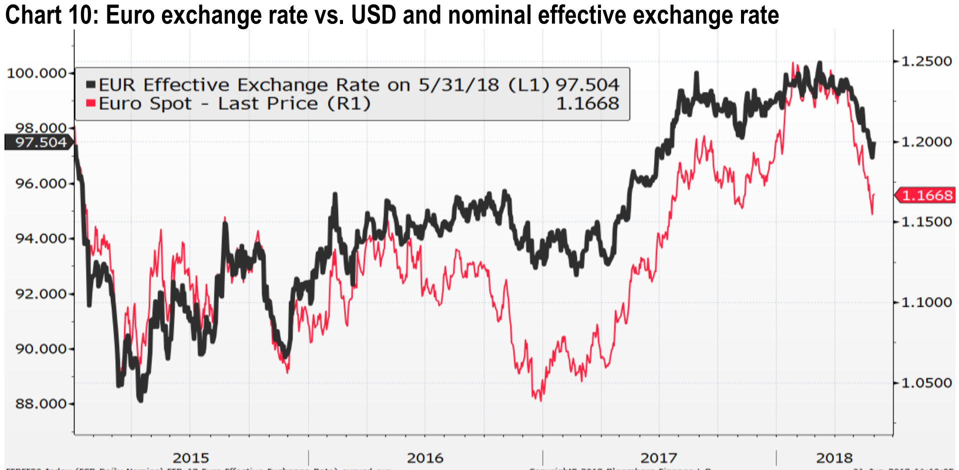
1) the upward surprise in the **May inflation number**, both in Headline and Core terms (1.9% and 1.1% from 1.2% and 0.7%, respectively, and both clearly above market expectations)

2) **Oil prices**, a variable the ECB has historically paid significant attention to, currently 18% above its level three months ago.

3) The **Euro exchange rate**, the main hurdle for the ECB to even mention the eventual end of its purchases, or potential rate increases until recently (remember Sintra almost a year ago) has recently fallen by 2.25% in NEER terms, and more than seven full figures vs USD (see Chart 10).

On the other hand, despite some easing in forward break-evens, it can really be argued that financial conditions have not tightened in the Euro area for the ECB to consider a delay of its slow official rates normalization process. In fact, Euro swap rates are now lower than last March.

Chart 10: Euro exchange rate vs. USD and nominal effective exchange rate



Source: Bloomberg, Santander

Accordingly, although the ECB will keep an eye on the potential electoral events in Southern European countries, **we believe macro conditions are** and should be, (please see the Economic section) **healthy enough for the ECB to start a gradual normalization process in official rates from mid-2019, leading its depo rate to nearly zero by the end of 2019**.

Economic Outlook: Running in a Hurdles Race

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This is an excerpt from our recently released "Thinking Macro 2H18" report published on the 30th May 2018, in which we analyse some of the themes that, in our view, are now in vogue.

The Euro zone keeps running in its hurdles race. If the probability of an economic cycle where everything runs smoothly is normally low, in the case of the Euro zone's the probability may actually be closer to zero. Since the end of the Euro zone recession, the economic recovery has travelled along a bumpy road where not all the Euro zone economies seemed to be on the same stretch of the road at the same time. Since 2017, there has been a synchronisation of the economic cycles, albeit with numerous obstacles (politics, weather, strikes, seasonality, flu epidemic) on the road. Like in a hurdles race, where athletes run while jumping over obstacles, we believe that better fundamentals should enable the Euro zone economy to run its race in 2018-19E at a GDP 'speed' of over 2.0%.

We analyse the present situation and prospects via a two-pronged approach, trying to isolate the most salient thematic issues from a transversal, cross-country perspective, and also probing the individual geographies in depth.

Macro themes. We use our economic "macro-scope" to shed some light on what we consider to be some of the most interesting aspects of the current economic situation, with a particular focus on the European economy:

- Current account, competitiveness and margins
- Economic Cycles
- Commodities
- Inflation
- Labour market
- Non-financial accounts
- Global investment

Geographies analysed in depth. We take a closer look at the specifics of the main economies in the region and those shaping the global conditions in which Europe operates, and present a full macroeconomic forecast for the countries covered:

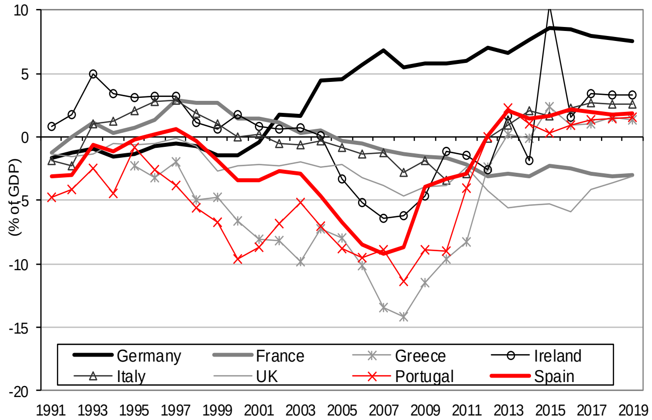
- A general framework of analysis for the Euro zone
- A detailed look at the major countries in the area: Germany, France and Italy
- An in-depth review of Spain and Portugal
- A detailed assessment of the US
- Global conditions

1.- Macro themes:

Current account, competitiveness and margins.

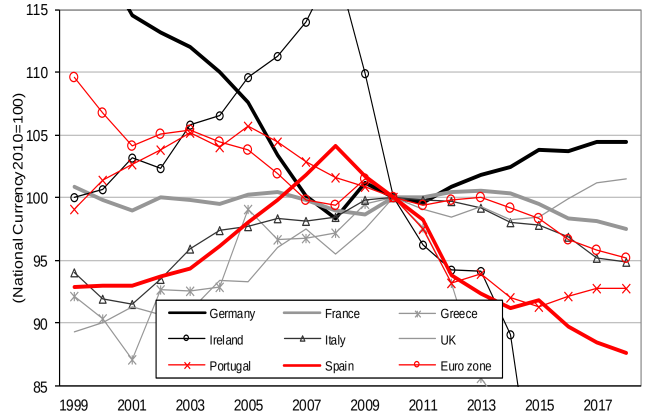
The Euro zone's net lending position is likely to remain stable in 2018E-19E. Most of the Euro zone countries maintain a surplus position. Interestingly, non-financial corporations (NFCs) have improved their net lending position, while households are moving into a net borrowing position in some countries. After a modest performance of trade numbers in 1Q18, we expect a recovery in 2Q18E, with Euro zone countries improving their competitive position after benefiting from adjustments in ULCs. Productivity figures are also improving, driven by investments, while margins remain stable or slightly lower.

Chart 11: Euro Zone – Net Lending/Borrowing as a % of GDP, 1991-2019E



Source: Eurostat, Santander.

Chart 12: Euro Zone – Nominal ULCs Perf Relative to the 37 Industrial Countries, 1999-2018E



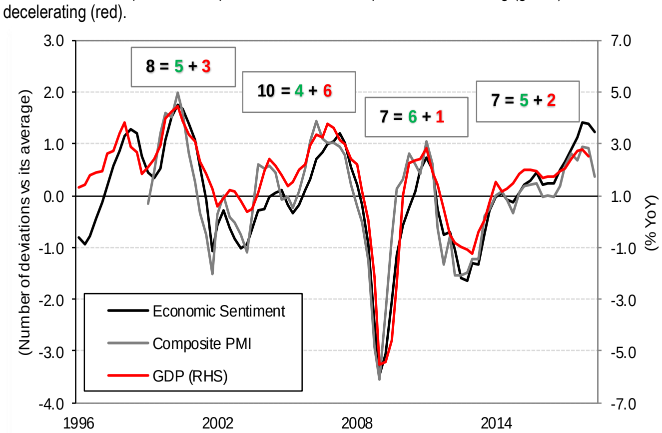
Source: Eurostat, Santander.

Economic Cycles

After several quarters of acceleration, we expect a moderation in confidence that should not necessarily mean that the positives for growth are gone. In fact, leading indicators point to a clear contribution to growth from private consumption and exports, with consolidated demand that is already generating tensions for companies' staffing and equipment. This also indicates a positive performance by investment and employment, which could extend the current positive cycle for longer.

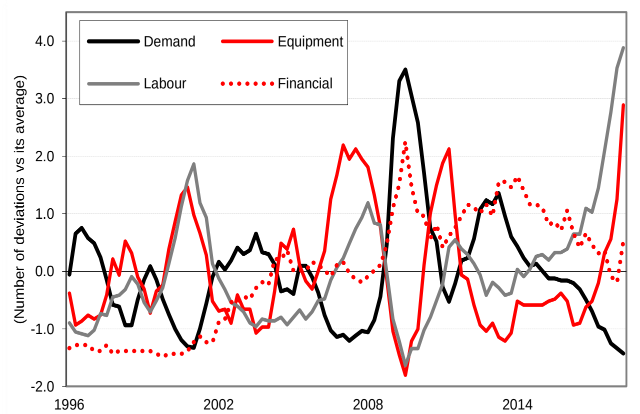
Chart 13: Euro zone – GDP and Confidence (*), 1996-2Q18

Boxes: number of quarters with positive confidence = quarters accelerating (green) + decelerating (red).



Source: Eurostat, European Commission, Markit and Santander.

Chart 14: Euro zone – Limits to Industrial Production, 1996-2Q18

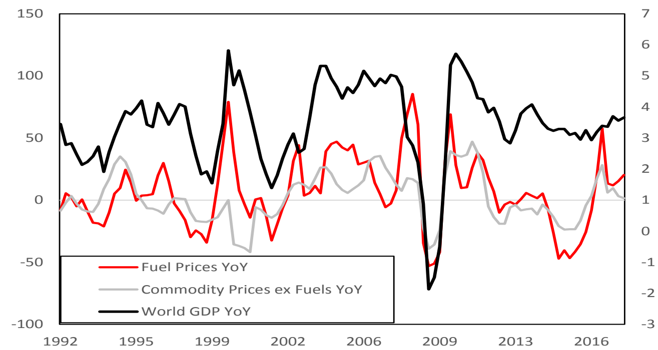


Source: European Commission and Santander.

Commodities

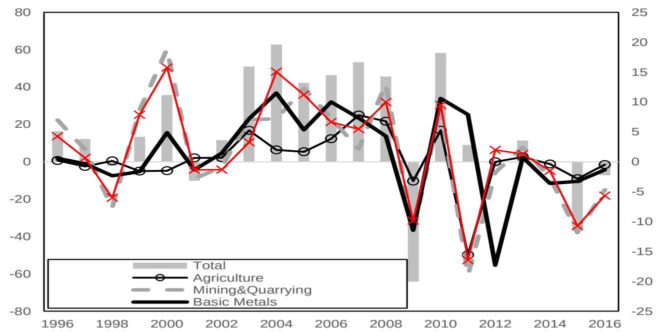
Since 2011-12, commodity prices have decoupled from the trade cycle, and we are in a period where, despite global growth, raw material prices are actually being contained. However, the volumes of commodities traded maintain some correlation with the components of orders and inventories of business sentiment indicators and show that current growth cycle still has further scope

Chart 15: Global – Commodity Prices vs World GDP, 1992-2017



Source: WTO and Banco Santander.

Chart 16: Global –Volumes of Raw Materials and World Trade (YoY %), 1996-2017

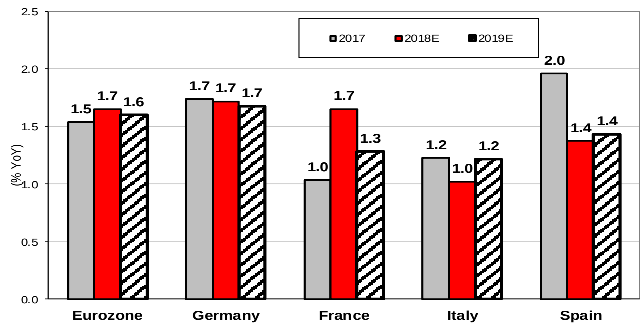


Source: WTO and Banco Santander.

Inflation

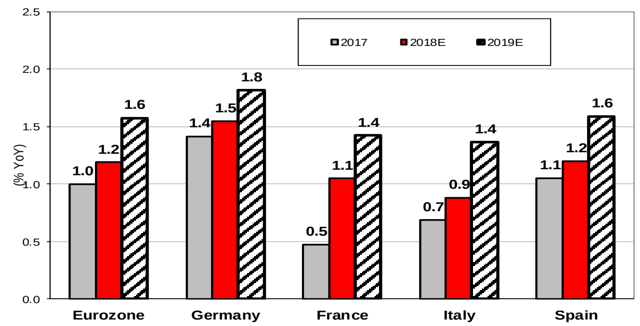
Euro zone inflation could average slightly above 1.5% in both 2018E and 2019E, with the main novelty being the rise in core inflation. The positive contribution from import prices could very likely continue, and we believe that the risks are clearly biased to the upside and mainly relate to the impact of the recovery in the labour market on unit labour costs and the companies' willingness to avoid a significant deterioration in their margins.

Chart 17: Euro Zone - Headline Inflation Forecasts, 2017-2019E



Source: Eurostat, Santander estimates.

Chart 18: Euro Zone – Core Inflation Forecasts, 2017-2019E

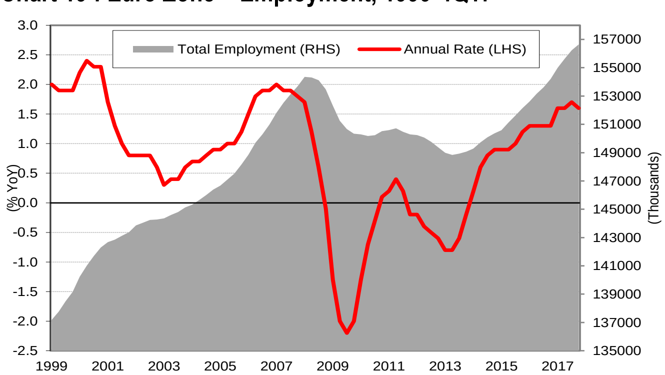


Source: Eurostat, Santander estimates.

Labour Market

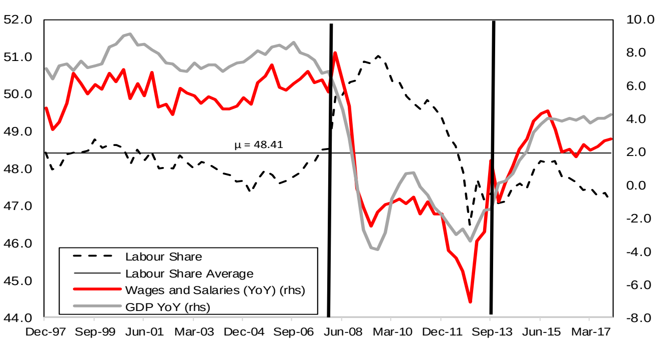
Labour share is still quite contained, especially in developed areas. However, there are major differences between countries with respect to salaries, and these depend mainly on the intensity of the implementation of structural reforms. These differences also depend on the sector. Note the significant role of non-recurrent remuneration as a way of maintaining employment

Chart 19 : Euro Zone – Employment, 1999-4Q17



Source: Eurostat, Santander.

Chart 20: Spain – Labour Share vs Growth and Wages, 3Q97-4Q17

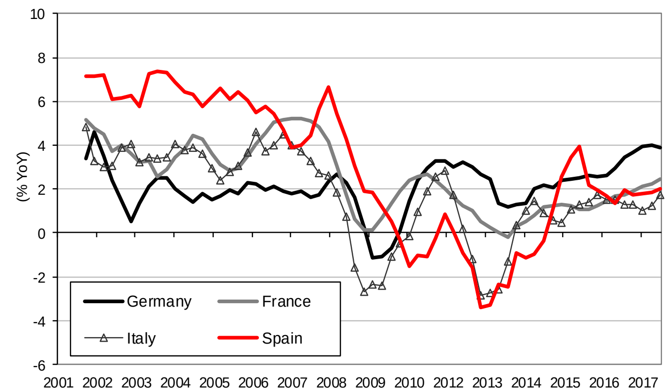


Source: INE and Santander

Non-financial Accounts

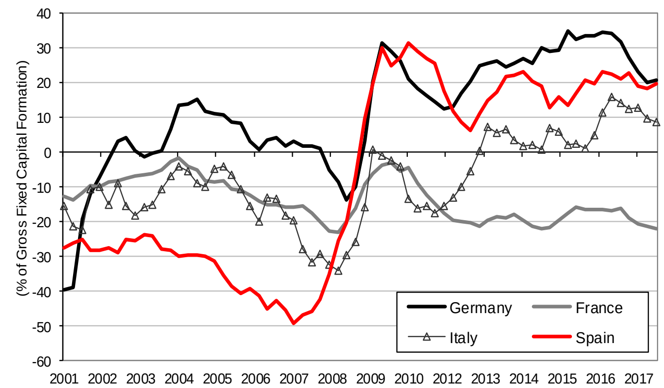
Income metrics continue to perform well. Households are getting more income, thanks to an acceleration in wages and salaries as a result of employment creation. The missing piece in the puzzle is still stronger growth rates in salary per employee. NFCs are also seeing their GVA growth rates moving upwards, with GOS growth rates turning up again. Lastly, the adjustment of the financial sector is progressing well, while governments continue to reduce their deficits

Chart 21: Euro Zone – Households GDI, 2001-3Q17



Source: INSEE, ISTAT, INE, Destatis and Santander.

Chart 22: Euro Zone - Non-financial corporations net lending/borrowing (as a % of GFCF), 2001-3Q17

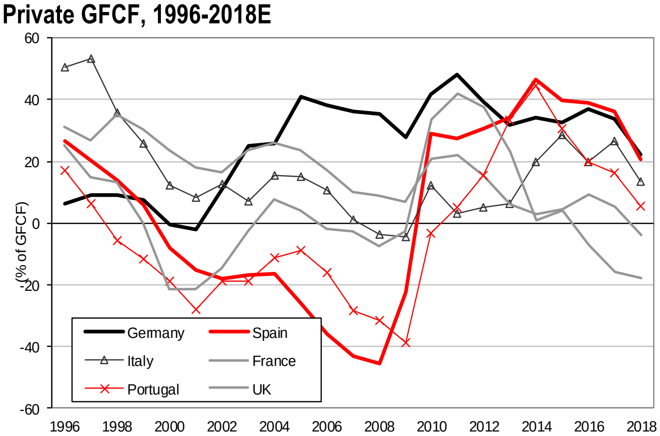


Source: INSEE, ISTAT, INE, Destatis and Santander

Global Investment

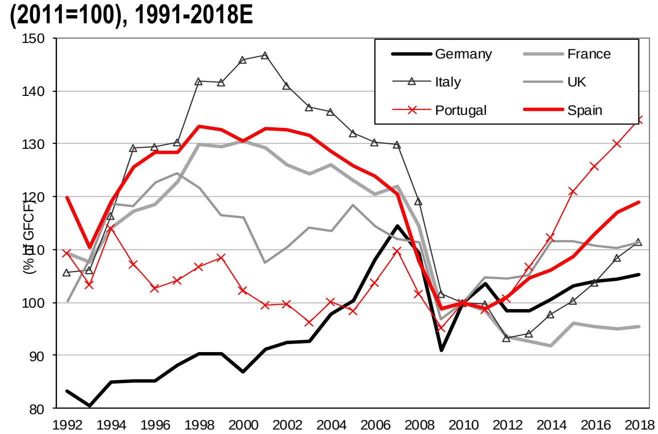
Investment has been accelerating mildly in the last two quarters, but net investment remains quite low, especially in construction. This should help extend the current growth cycle in time. Moreover, households and corporations have low leverage levels, enabling them to use cash for these investments. In any event, corporates tend to use alternative sources of funding, and this leaves more scope for growth, which should help to maintain the current growth cycle.

Chart 23: Euro Zone – Private Sector Financing Gap (% of Private GFCF, 1996-2018E



Source: Eurostat, Santander.

Chart 24: Eurozone – Net Returns on Capital Stock (2011=100), 1991-2018E



Source: Eurostat, Santander

2.- In-depth probes, by geography:

Eurozone (2.3% 2018E, 2.2% 2019E)

We have slightly reduced our GDP estimate for 2018 to 2.3% (2.4% previously), while leaving 2019 at 2.2%. Despite lower-than-expected quarterly growth rates in 1Q18, we believe that economic fundamentals are strong enough to support 2.0%-plus GDP growth rates in 2018E-19E. Internal demand should still be the main driver of growth.

According to our estimates, all four of the largest economies but Italy should grow by more than 2.0%.

Germany (2.3% 2018E, 2.2% 2019E)

After a poor 1Q18 in terms of trade, but with a very positive performance of investments, we believe that growth in Germany will pick up again already in 2Q18E. In fact, the one-offs that have weighed on trade dynamics are disappearing, and this, together with the strength of the labour market and the acceleration of investments, is likely to speed up growth already in 2Q18E.

France (2.1% 2018E, 2.4% 2019E)

We have reduced our 2018 GDP estimate to 2.1% (2.4% previously) due to lower-than-expected growth rates in 1Q18. We expect the economy to grow more than 2.0% due to stronger fundamentals. Investments should outperform, with private consumption growing below the 2.0% mark. Importantly, the contribution of net exports to GDP growth should improve significantly in 2018E, after being very negative in previous years.

Italy (1.4% 2018E, 1.6% 2019E)

We have cut our 2018 growth estimate slightly (previously 1.5%), while raising that for 2019 (also from 1.5% YoY). We estimate that fundamentals are good enough to keep private final sales positive, mainly driven by investment and exports. That said, political issues are a major source of uncertainty hanging over this economic scenario.

Spain (2.9% 2018E, 3.0% 2019E)

We have not changed our 2018-19 forecasts. We think the economy can still deliver 2.5%-3.0% GDP growth rates in the coming years. Internal demand continues to perform very well, with exports also showing positive figures. The strength of private sector balance sheets underpins this economic cycle. In our view, the key for extending the cycle, and delivering 2.5%-plus GDP growth, lies in the future acceleration of salary per employee.

Portugal (2.0% 2018E, 1.8% 2019E)

Exports continued to be the main pillar of economic growth during 1Q18 (albeit decelerating). Investment dynamics are still being supported by domestic demand, while private consumption continues at a more moderate pace. Public consumption is expected to pick up in the coming quarters, and net exports should perform at close to breakeven levels, as real exports could reach 50% of GDP in 2018E.

United States (2.8% 2018E, 2.7% in 2019E)

We have raised our GDP estimate for 2018 to 2.8% (2.5% previously) and for 2019 to 2.7% (2.6% previously). While we did not incorporate any of the possible fiscal measures to be included in President Trump's fiscal reform in our previous forecasts, we now take into account the approved measures. The result of that adjustment is higher growth rates in both 2018E and 2019E, higher fiscal deficit estimates and a slightly worse current account position.

Global Conditions

Inflation generally remains under control. Since the beginning of the year, the slowdown in trade has given rise to uncertainty regarding global growth. Based on the leading indicators, the still accommodative financial conditions and the recovery of commodity prices, we believe the global cycle is likely to accelerate again.

US Rates Strategy: No changes in the medium-term picture

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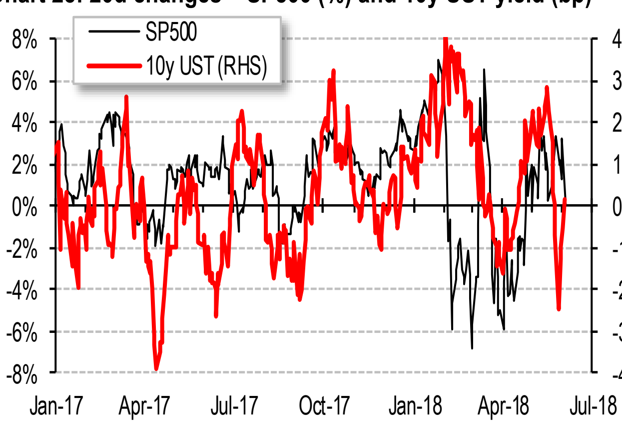
- **The increased political uncertainty in the Eurozone has revived the appetite for perceived safe havens, globally, in the past few sessions. And USTs have rallied, consequently, as part of the risk-off move.**
- **We expect the US rates market to remain driven by risk aversion flows and, therefore, directionality will be determined by the developments in the Eurozone in the short run. But, if the situation stabilized somewhat in the weeks to come, we find that the magnitude of the actual changes registered in US markets until now should be, according to historical records (and while the past is no indicator of the future), still far from causing a significant change in the expectations for inflation, growth or monetary policy in the US. And therefore, we believe it is too soon to expect any reaction from the Fed on the back of recent events, yet.**
- **Therefore, we are closely monitoring developments in the Eurozone but see no reason yet to change our year-end call for US rates and monetary policy. We remain positioned for higher rates particularly in the front end (carry-efficient alternatives in the belly and the long end.**

The perceived safe-haven bid holds the 10y UST back below the 3% mark again

Recent developments in the political arena in Italy and, to a lesser extent, in Spain (see the EUR Rates section) have changed the overall picture in global markets, including those in the US. As regards US rates markets, we have witnessed a U-turn in sentiment, with investors' concerns shifting from the threat of a bearish trend building up, to a sudden revamp in demand for USTs as part of the risk aversion flows coming from Europe. Specifically, the 10y UST that was closely after having broken the "key" 3% level, is trading now well below that mark (and it seems it could take a while until it returns to the 3.10% levels seen by mid-May).

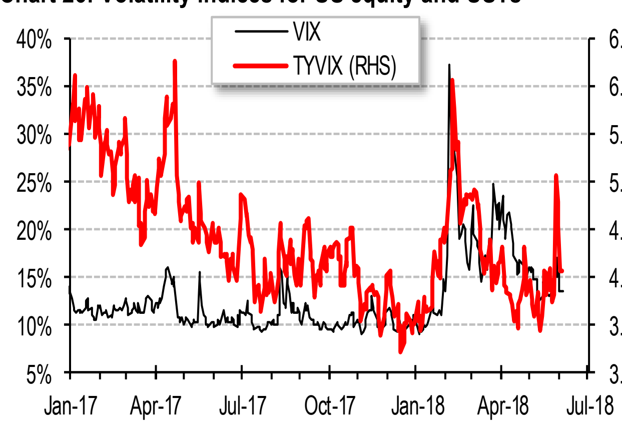
But, interestingly, if we focus just on US assets, actual market changes do not look particularly 'worrisome'. Certainly not as much as in some other European markets, and we would say that not even as intense as in other recent stress episodes. As shown in Chart 25 and 26, actual changes in US equity indices or UST yields during the past few sessions are even lower than in other recent episodes of volatility.

Chart 25: 20d changes – SP500 (%) and 10y UST yield (bp)



Source: Bloomberg, Santander.

Chart 26: Volatility indices for US equity and USTs



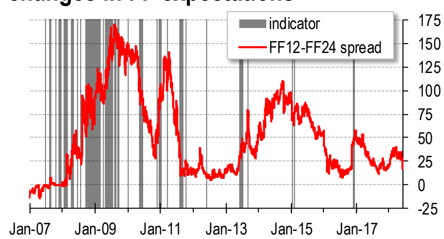
Source: Bloomberg, Santander.

Will recent market volatility have an impact on the FOMC? Not likely, for the time being

In the past, we have seen that the Fed has somewhat altered its monetary policy when facing violent market changes (we caution that the past is no indicator of the future). Especially when that market volatility was driven (or finally drove to) changes in macro expectations. It is only natural that, after the events that have taken place in the past few sessions, some might wonder whether or not we could see the Fed altering their plans in the next few weeks.

We believe that the answer to that question, at this moment, is that the price action seen in US assets so far is unlikely to cause the Fed to be on the verge of introducing changes in its planned monetary policy just on the back of recent price action. In fact, we find that the situation in Italy should likely need to get significantly worse (and/or risk aversion flows intensifying in the US) to have an actual impact on macro expectations. The rationale behind this affirmation is that we think that only a market movement that is strong enough as to materially change macro expectations would push the Fed into reconsidering their monetary policy stance (and we find some past evidence of this in our analysis, as shown in Chart 27). And that does not seem to be the case, for the time being.

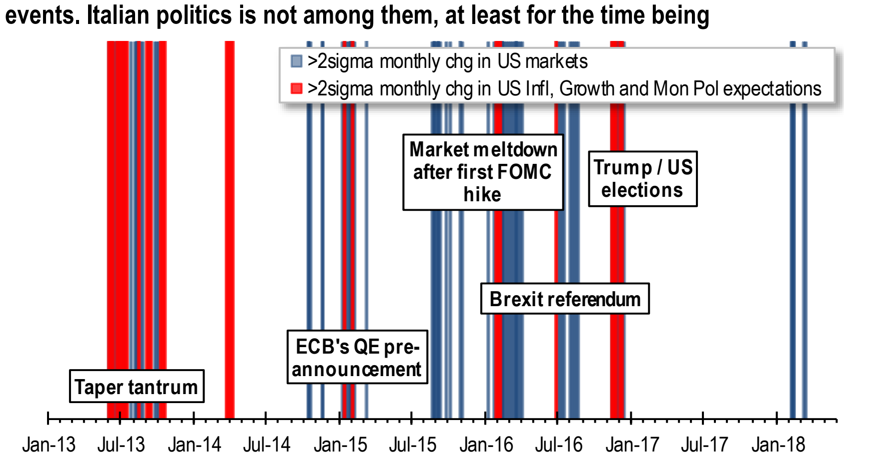
Chart 27: Santander's Taylor-made indicator of moments when the Fed can change monetary policy vs actual changes in FF expectations



Source: Bloomberg, Santander.

In Chart 28 we identify periods in recent history (since 2013) when we saw sizable changes in US markets (blue bars) and also relevant changes in macro expectations priced in by the market (red bars). Over the past 5 years, we can identify five occasions when we had significant changes both in market levels and in macro expectations which (incidentally?) coincide with the main events we have lived in the markets, globally, during that time. Without entering into the discussion on whether it was macro expectations causing the market changes or the other way around for each of these past events, the key is that the magnitude of the recent market turmoil, as regards US assets, was not even big enough as to appear in the chart (the last two blue bars in the chart correspond to the sudden decline seen in US equities in February and March, respectively). Hence, still far from becoming an event that might lead to significant changes in US macro and monetary policy expectations.

Chart 28: The periods when sudden market changes coincided in time with a significant in medium-term macro expectations have historically to very remarkable events. Italian politics is not among them, at least for the time being



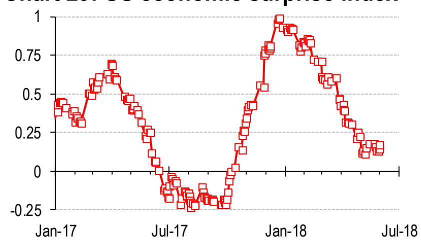
We use the SP500, the 10y UST, the VIX, the TYVIX and the 1m10y swaption vol as US market indicators.

We use the FFF1-FF12 spread and the FF12-FF24 spread as monetary policy expectations' indicators, the 5y5y in USD IL swaps as a medium-term inflation expectations' indicator and the spread between 5y5y USD swaps and 5y5y USD IL swaps as a medium-term growth expectations' indicator.

Source: Bloomberg, Santander.

This leads us to believe that, while the Fed will likely continue to monitor the developments in the Eurozone markets (and might stand ready to react, if needed), we are still at a point in which recent market volatility is still not a variable that could make them change their call on monetary policy.

Chart 29: US economic surprise index

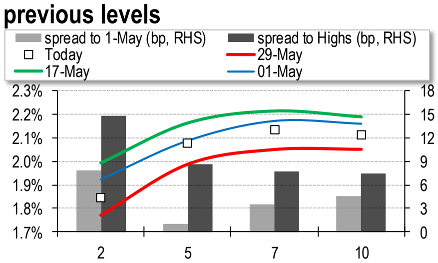


Source: Bloomberg, Santander.

On the other hand, actual macro data released in the past few weeks has remained solid, and the indicator of macro surprises in the US (Chart 29) shows that, after several months of a gradual decline (indicating that macro data was surprising to the upside but not as much as in previous months), it has started to bounce back.

This makes us feel comfortable with our long-held call for monetary policy and rates in the US, and unless market volatility intensifies and/or macro data starts to disappoint, we are not altering our views for the time being. If the Fed goes ahead in hiking the FF rate this and next year just as depicted in their dot chart, we continue to think the 2y2y should not only return to the highs seen two weeks ago but even keep increasing towards the 3.25% area (hence maintain our trade open). As for the belly of the curve, in our opinion we will see higher rates later on the year, but still think the bearish trend will not be particularly intense in the next few weeks (so we cling to our carry-efficient shorts, like paying the belly in 2s5s10s, rather than outright, negative-carry positions).

Chart 30: US Breakevens – the 2y still has room to increase, just to get back to previous levels



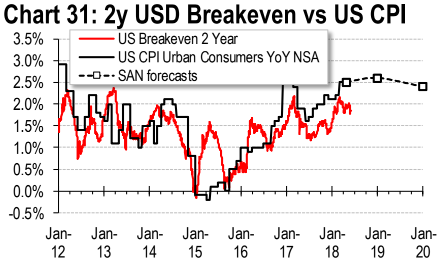
Source: Bloomberg, Santander.

So, the medium-term outlook remains unchanged. Let's focus on possible dislocations caused by recent volatility

Having said that, experience in previous episodes of volatility similar to the one registered in the past few sessions suggest that these sudden changes in market levels tend to generate dislocations, as less liquid assets (and/or crowded positions) tend to lag (or overshoot) in fast market movements.

A quick look to the different UST, nominal swap, IL swap, breakeven and swap spread curves in the US, comparing current levels with the range seen between the latest highs (on 17 May) and the latest lows (on 29 May) and the average levels seen just before the market turmoil suggests that front-end inflation looks like a potential candidate for proving a dislocation. As shown in Chart 30, current levels are still 15bp below the highs seen on 17 May, and indeed c.10bp below the levels seen one month ago (while other tenors, like the 5y, have already converged to last month's levels).

Chart 31: 2y USD Breakeven vs US CPI



Source: Bloomberg, Santander.

Also, form a fundamental perspective, we think that current 2y breakeven levels appear cheap compared to the recent (and expected) performance of inflation in the US. In Chart 31 we show the historical correlation between the 2y breakeven rate and the actual US CPI figure published every month, as well as our economists' forecasts for inflation this year and next (see their [Thinking Macro 2Q18 report](), published on 30 May). We think there is room for further increases in the 2y breakeven rate, which should at least ensure this indicator returns, at least, to the 2% mark seen just one month ago.

Trade idea: Buy the 2y USTi breakeven
Entry level = 1.85%. Target level = 2%. Stop loss = 1.8%

Euro Rates Strategy: Italian political uncertainty dominates market dynamics

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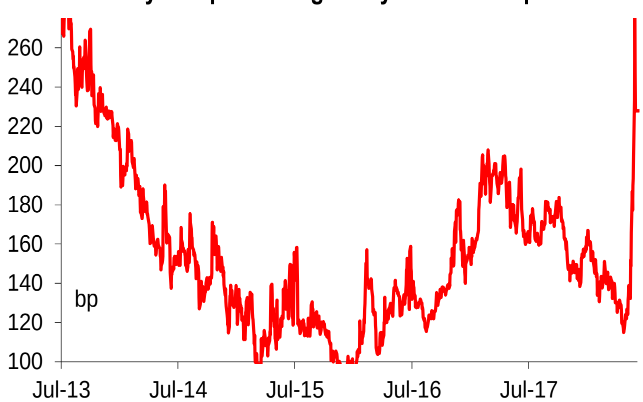
- **Most levels and spreads in EUR rates markets have recently been driven by the sharp risk-off move linked to the Italian political and policy uncertainty.**
- **We doubt that over the next few weeks investors will have a definitive take on that risk but, with a new government being formed, the market should enter a less agitated, transitional phase.**
- **Spreads (such as SPGBs, core ASW) that have moved largely on the back of the risk-off momentum, as opposed to fundamental change, should correct back.**

Driven to distraction by Italian politics

In the previous edition of I&E, we opined that Italian political risk was "under-priced". What an understatement that proved to be. Relative to the end of April, the 10y BTP-Bund sovereign risk yield premium (the spread) moved sharply wider, reaching levels well above 280 bp; and above 300 bp intra-day. Over the past couple of weeks, despite relevant news flow elsewhere, **events in Italy have been the main driver not just of Italian sovereign spreads but of other EGB spreads and direction as well**.

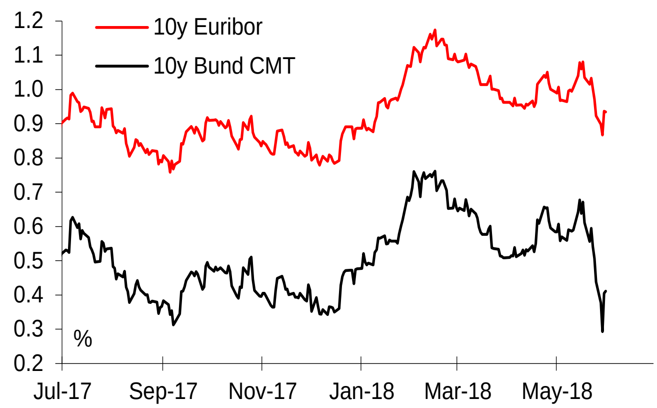
On the direction front, as recently as two-three weeks ago, at a time when the 'populist' coalition was already in the process of trying to form a government in Italy, the 10y Euribor rate was creeping upward. More recently, however, it has corrected sharply lower, led by German yields. The 10y Bund is back to levels from before the December-February sell-off and the z-spread on the Schatz is 15bp wider than its recent lows.

Chart 32: Very sharp widening in 10y BTP-Bund spread



Source: Bloomberg, Santander.

Chart 33: Risk-off momentum returns to core rates



Source: Bloomberg, Santander.

Given the all-consuming interest in Italian politics, currently the key questions for EUR rates investors are likely to be:

1) What happens next in Italy?

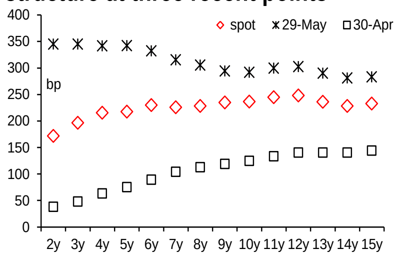
2) Can price action in other EGBs decouple from events there?

3) If decoupling occurs, what represents good value in EUR rates?

Recent past and near-term outlook in Italy

After an indecisive March election and two months of inconclusive talks, markets had assigned no extra risk premium to Italian debt. Once the 'populist' 5-Star movement (M5S) and League began trying to put together a coalition government, spreads started to widen, especially after fiscally very lax, politically nationalist policies were included in the coalition 'contract'. The candidature of a clearly Euro-sceptic economist (Savona) as Finance Minister exacerbated price action.

Chart 34: BTP-Bund spread term structure at three recent points



Source: Bloomberg, Santander.

M5S-League government formation efforts foundered, ostensibly due to President Mattarella's vetoing Savona's appointment. The president then gave the PM mandate to former IMF functionary Cottarelli but, at the time of writing, the pendulum had swung back to a 'political' government by M5S and League (with Conte as PM and a more pragmatic Finance Minister, Tria).

There is **no certainty as to what policies such a government will pursue or how long it will last**. If Italy returned to elections, based on current opinion polls, one would expect the League and M5S to wield as much influence, if not more, as after the March vote. At the same time, the episode of spread volatility and the cautious bidding at the 10y auction have probably served as a reminder that Italy's room for manoeuvre is limited.

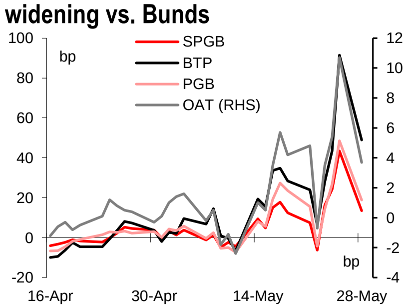
The ambivalent statements in recent sessions suggest it is **simplistic to think of a potential M5S-League government as being strongly committed to exiting EMU**. Given the size of Italy's debt and economy, within EMU, some sort of compromise between the institutions and a populist government should not be ruled out. Some fiscal loosening seems likely but the extent is far from clear.

If spread volatility were to decrease further, that should give investors more time to reflect and open the way for a **decrease in the degree of directional correlation and periphery spread 'contagion'**. The main threat to a normalisation in spreads, assuming a quieter political setting in the near term, would be a sharper than expected drop in economic confidence indicators or ratings downgrades.

Policy risk in Spain looks limited

As recently as late last week, there was very little in terms of domestic developments to justify or explain the substantive widening experienced by SPGBs relative to Bunds – about 20 bp in 10y maturity since the end of April. That changed on Friday, 25 May, when the Socialist Party (PSOE) raised a no-confidence motion in parliament against the minority government run by the conservative Popular Party (PP) and the latter's main indirect supporters, the Citizen's Party (Ciudadanos) called for a change in PM or new elections. Although the volatility of SPGB-BTP spreads continues to be much less than that of BTP-Bund spreads, clearly there have been **more questions about the political situation in Spain**, from international investors.

Chart 35: Correlated EGB spread widening vs. Bunds



Source: Bloomberg, Santander.

Note: Series show the 3-day rolling spread change.

The overall situation, however, bears **very little similarity to that of Italy**. Should the vote, on Friday, result in new elections, **the leading parties vying for power are quite similar in their supportive stance towards EMU membership**. The more openly left-wing populist Unidos Podemos electoral alliance attracted a lot of investor attention in 2015-16 but, as things stand, the focus is on PP, PSOE and Ciudadanos. In other words, **the degree and perception of policy risk seems much more contained**.

In addition, the **underlying macro conditions** in terms of nominal and real growth and of debt and ratings dynamics **remain quite supportive**, for SPGBs. If we compare the political situation now to the uncertainty after the 2015-16 votes or even the Catalan referendum of last October, which ultimately did very slow Spanish growth much, we should be relatively sanguine about macro prospects.

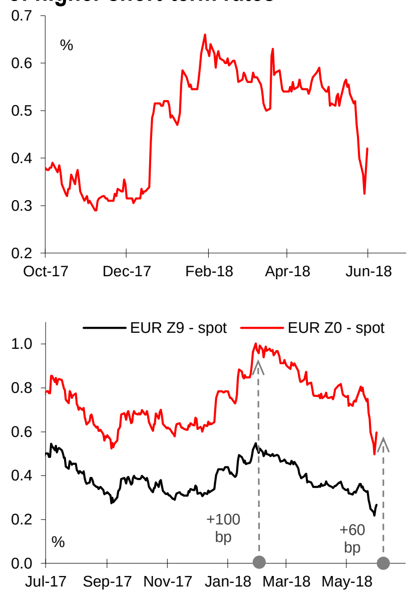
Direction reflects risk-aversion, not a proper change in ECB or macro expectations

Directional price action over the past couple of weeks has been driven mostly by the 'risk-off' sentiment created by the Italian political situation. However, to get a sense of where core rates might head once spreads stabilise we need to check where they were headed before the current volatility began.

Recall that the ECB policy meeting in April was a near-complete wash-out, other than to point out that the ECB was still waiting for evidence that its inflation target would be within reach. The account released since then basically confirmed the tone of the discussion within the Governing Council. The upcoming meeting on June 14 is unlikely to provide more clarity, even though it will contain updated staff forecasts.

In terms of data releases PMI and GDP data has shown, if anything, more retrenchment, although Some of that deceleration is probably attributable to calendar and weather effects. At least, core HICP seems to have rebounded from an ultra-low 0.7% y/y, in April, back to 1.1% in May, still well below 2%. Even before the potential noise created by the Italian political situation, the overall picture is not one that suggests the ECB will move towards a policy decision at this meeting.

Chart 36 – 37: Reduced expectations of higher short-term rates

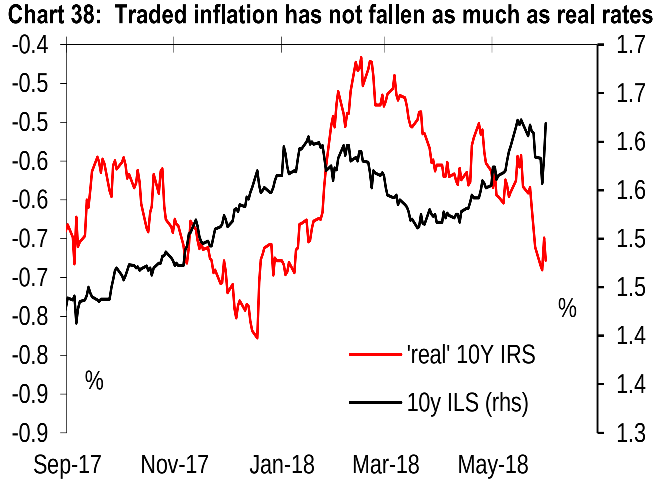


Source: Bloomberg, Santander.

Reflecting those considerations, the timing of ECB policy tightening had been slipping backward even before recent political events. The recent move, however, is on an entirely different scale. In the context of that risk-off directional move, we note that, even before the rally in core EGBs began, real rates had been falling relative to traded inflation levels. It seems therefore likely that if the situation stabilises somewhat, real yields should account for much of the rise in overall nominal rates.

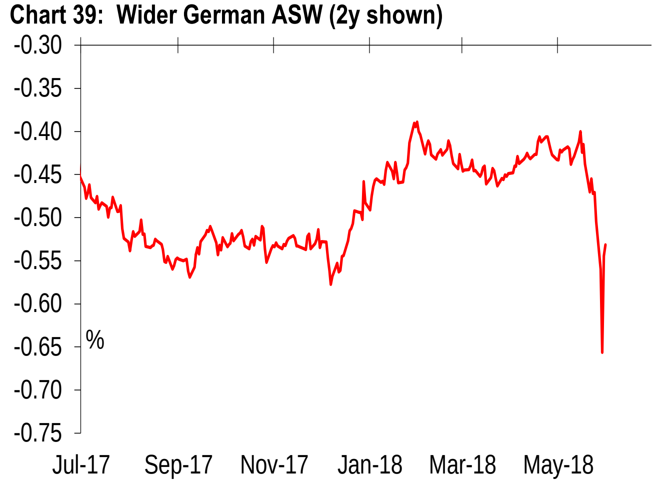
A similar pattern of risk-off effects is of course visible in the Schatz and OBL spreads to Euribor, which at one point widened by 20-30 bp. No such trend was visible at all before the recent events in Italy. Furthermore, financing spreads have not widened by a commensurate amount and have been rather stable since the ECB made repo lending of PSPP holdings more straightforward in early 2017.

Chart 38: Traded inflation has not fallen as much as real rates



Source: Bloomberg, Santander.

Chart 39: Wider German ASW (2y shown)

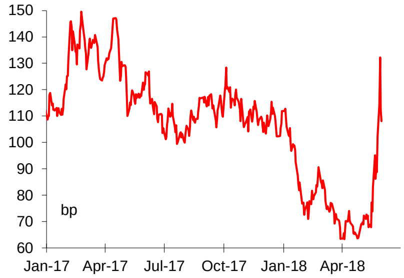


Source: Bloomberg, Santander.

Conclusions and positioning

At the time of writing, although a M5S-League government looked a done deal, there remains considerable uncertainty about and policy risk in Italy and the direction and duration of such a government. Under such conditions, there is understandable reluctance to enter trading positions. However, we do not believe that risk aversion will retain the current fever-pitch indefinitely, even if Italy enters another election campaign period. Under less volatile conditions we think the following trades could perform well, while somewhat limiting downside exposure if tensions persist for longer than we anticipate.

Chart 40: Spain-Bund 10y spread back at 2017 levels



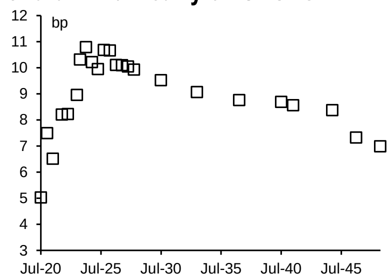
Source: Bloomberg, Santander.

Trade idea: SPGB outperformance

The most basic positioning idea here is not to dump at cheap prices the considerable long positions that many investors still retain.

An investor that wants to put on a brand new position should consider the relatively cheap 7y to 10y area. For instance SPGB 1.6% Apr-2025 or SPGB 1.4% Apr-2028.

Chart 41: 6m carry on SPGBs



Source: Bloomberg, Santander.

Trade idea: Higher real rates

Pay 10y Euribor IRS
Receive 10y ILS (Emu ex-tob. HICP)

The entry spread is -0.70%. Target a spread of -0.45% bp

Trade idea: Reverse asset swap the 2y Schatz

RASW Schatz 0% Jun-2020

The entry level is Euribor -53 bp. We would target a return to Euribor -40 bp.

Euro government bond supply: YTD update

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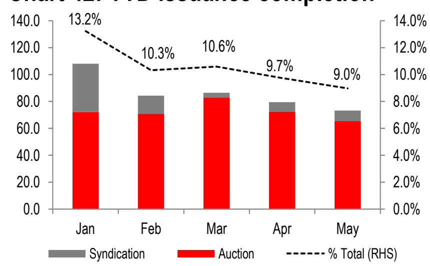
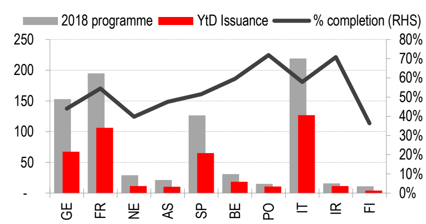
Chart 42: YTD issuance completion



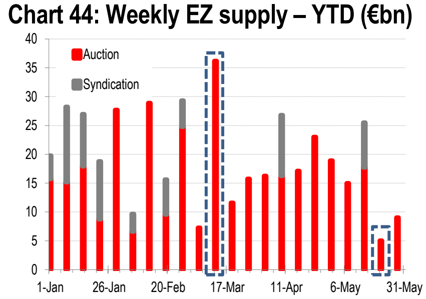
Source: Bloomberg, Santander

Chart 43: 2018 YTD issued vs. target



Source: Bloomberg, Santander

Chart 44: Weekly EZ supply – YTD (€bn)



Source: Bloomberg

Table 3: YTD issuance completion vs. historical data

	2013	2014	2015	2016	2017	2018	Aver 13-17
GE	43%	44%	45%	44%	44%	**44%**	44%
FR	51%	48%	48%	49%	49%	**54%**	49%
NE	52%	61%	56%	41%	54%	**40%**	53%
AS	43%	53%	30%	47%	47%	**47%**	44%
SP	54%	53%	49%	47%	49%	**52%**	50%
BE	56%	59%	53%	52%	59%	**59%**	56%
PO	100%	41%	63%	65%	58%	**72%**	65%
IT	48%	52%	54%	49%	51%	**58%**	51%
IR	100%	55%	78%	67%	49%	**71%**	70%
FI	37%	46%	57%	56%	58%	**36%**	51%
TOTAL EZ (€)	**50%**	**51%**	**50%**	**48%**	**50%**	**53%**	**50%**

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

Year-to-date, EUR issuers as a whole have completed more than 50% of their 2018 issuance requirements

EUR issuers have sold more than €430bn in bonds (of the €817bn total) via both ordinary auctions (€364.1bn) and syndicated deals (€67.7bn) up to the end of May. Chart 42, however, highlights how EUR countries decrease their issuance this month, compared with April and March. It is important to note the slight drop in auctions was perhaps caused by the current political instability in Italy, despite the issuance of the first BTP Italia of the year.

May's total supply activity was limited to €73.3bn, or 9% of the Eurozone's 2018 combined issuance requirements (vs. the 11% average seen in the first four months of the year), with the Eurozone's weekly average falling to €19.6bn from the €21.1bn average seen during the first four months of the year. So, once again, the second full week of March (commencing 12 March) was still responsible for the largest weekly volume so far this year, with €36.2bn placed, while the week commencing 21 May saw the lowest volume, with just €5bn (Chart 44).

Summarizing the first five months of 2018 in terms of year-to-date issuance (shown in Table 2), as at 31 May, Italy continues at the forefront, with c€127bn, followed by France, with €106.2bn. Germany comes in third, with €67.3bn, and Spain fourth, with €65.1bn in SPGBs and linkers. Above the €10bn mark, we find Belgium a distant fifth, with €18.4bn, followed by the Netherlands (€11.5bn), Ireland (€11.3bn), Portugal (€10.8bn), and Austria (with €10.2bn). Finland has not reached the €10bn point yet (€4bn), and remains at the bottom of the ranking.

In terms of YTD completion rates by country, Portugal and Ireland are still at the top, leading the Euro area issuer ranking with more than 70% (at 72% and 71%, respectively). Belgium and Italy are very near the 60% mark and come next with 59% and 58%, respectively, while France is at 54%, closely followed by Spain (with 52%) in the 50%-plus club. Austria (47%), Germany (44%), and Finland (36%) are lagging behind, with seven more months ahead to recover and fulfil their 2018 funding requirements (see Table 2 for details).

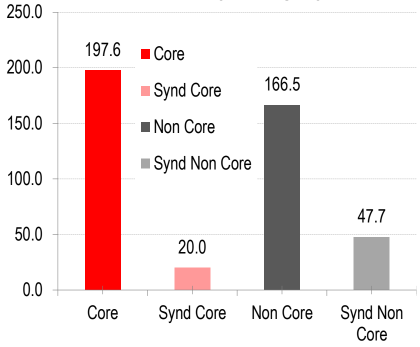
Table 2: Total issued in EZ in 2018, by country (updated as at 31 May)

	GE	FR	NE	AS	SP	BE	PO	IT	IR	FI	TOTAL EZ (€bn)
YtD auctioned issuance	67.3	102.7	11.5	6.2	49.1	8.9	3.8	110.2	3.3	1.0	364.1
YtD syndicated issuance	0.0	3.5	0.0	4.0	16.0	9.5	7.0	16.7	8.0	3.0	67.7
YtD Issuance	67.3	106.2	11.5	10.2	65.1	18.4	10.8	126.9	11.3	4.0	431.8
2018 programme	153.0	195.0	29.0	21.5	126.3	31.0	15.0	219.0	16.0	11.0	816.9
% completion (RHS)	44%	54%	40%	47%	52%	59%	72%	58%	71%	36%	52.9%

Source: Bloomberg, Treasury Agencies

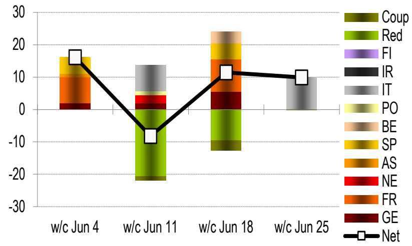
When comparing 2018 to last year's completion rates, four Eurozone issuers have stepped up the pace this year (Ireland, Portugal, Italy and France). Also, the combined average at this point of the year is slightly higher than the rate last year (53% vs. 50%). Thus, most Euro area issuers are achieving their targets at a healthy pace, with the notable exception of the Netherlands and Finland, which are behind by 14pp and 21pp, respectively. On the other hand, Ireland, Portugal, Italy and France are well ahead this year, exceeding their 2017 averages by 21pp, 14pp, 7pp, and 6pp, respectively along with Spain (+2pp), Austria and Belgium (+1pp in each case) - see Table 3. Lastly, Germany as usual has issued about the same amount of paper YTD as at this point of 2017.

Chart 45: Issuance by category – YTD



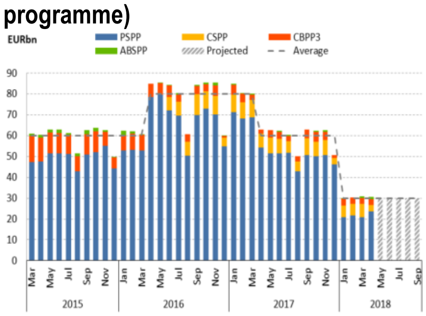
Source: Bloomberg

Chart 46: Expected EUR bond net supply (€bn)



Source: Bloomberg

Chart 47: The ECB's EAPP portfolio: monthly net purchases, by programme



Source: ECB

Core issuing a bit more than periphery countries

This month, there was no activity in syndicated deals, and Italy was able to place its first BTP Italia of the year. The issuance pace has decreased from c.€80bn in April to €73bn in May. The auction activity dropped to €65.6bn (from €73bn in April), the lowest level seen in the year, breaking February's €70.8bn level. In May, the core countries as a whole have issued €37.2bn, compared with just €28.4bn from their periphery counterparts. So far this year, core issuers account for 50.4% of the total, the equivalent of c.€218bn, while periphery supply makes up the remaining 49.6%, or €214.2bn. (Chart 45).

The core countries have auctioned 1.19x more than the periphery (€197.6bn vs. €166.5bn) so far in 2018, while the non-cores have placed 2.39x more via syndicated deals (including retail bonds) than their core counterparts (€47.7bn vs. €20bn).

Another month of positive net euro supply

In June, we expect more than €65bn in new auctions (not including syndicated deals). We expect France and Italy to issue around €18bn each, Germany €10-11bn and Spain €10bn. Also, the Netherlands will be reopening its 5y DSL via DDA for up to €2.5bn and Belgium is scheduled to issue an estimated €2-3 bn of debt in the week commencing 18 June. Portugal, Ireland and Finland could issue debt either by auction or syndication in June. However, scheduled redemptions of more than €30bn and coupon payments of €4.5bn will not be enough to offset June's supply. Consequently, EUR net issuance will stay in positive territory for the next four to five weeks (Chart 46).

Update of the ECB's EAPP

On 28 May, the ECB published the latest figures for its Extended Asset Purchase Programme (EAPP) holdings, which include the purchases settled as at 25 May. According to the latest report, **PSPP** holdings now stand at €1,987.8bn, **CBPP3** holdings at €253.3bn, **CSPP** total is at €155.6bn, while **ABSPP** holdings have remained at €27.2bn, taking the total EAPP portfolio to €2.424bn (of which 82% relates to the PSPP account, while the CBPP3, CSPP and ABSPP represent 10.4%, 6.4% and 1.1%, respectively). According to the overall figures, with one week left to the end of May, the average increase in total purchases in the last four weeks stands at €5.4bn (which is lower than the average of €6.6bn since January). So, in order to reach the €30bn/month target, next week's report should show a significant increase in the weekly average.

Country-wise, the latest information available is a breakdown of the PSPP debt security holdings published by the ECB on 7 May. The April figures show that the EAPP grew by €30.6n in April (€309mn less than in March, or a 1% decrease), of which €23.6bn corresponded to the PSPP (more than last month's €20.8bn). Of these €23.6bn, €21.2bn were Euro-denominated public debt securities including agencies (€2.6bn more than in March), and the remaining €2.4bn (again, 10% of the PSPP) are supranational debt, c.€300mn more than the previous month. More specifically, the April numbers show an increase in almost all the countries, with the exception of Malta and Germany. Meanwhile, the increases in France (+€575mn), Italy (+€549mn) and Spain (+€345bn) represented more than 51% of the rise in last month's PSPP buying (see more details here).

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- **Market expectations around the path of UK Bank Rate have proved fluid in recent weeks…**
- **…but with the implied probability of a 2018 rate hike remaining close to the 50% level, hawkish sentiment has proved durable**
- **We expect this hawkish sentiment to fade in the coming weeks, as weak activity and inflation data combine with continued Brexit uncertainty.**

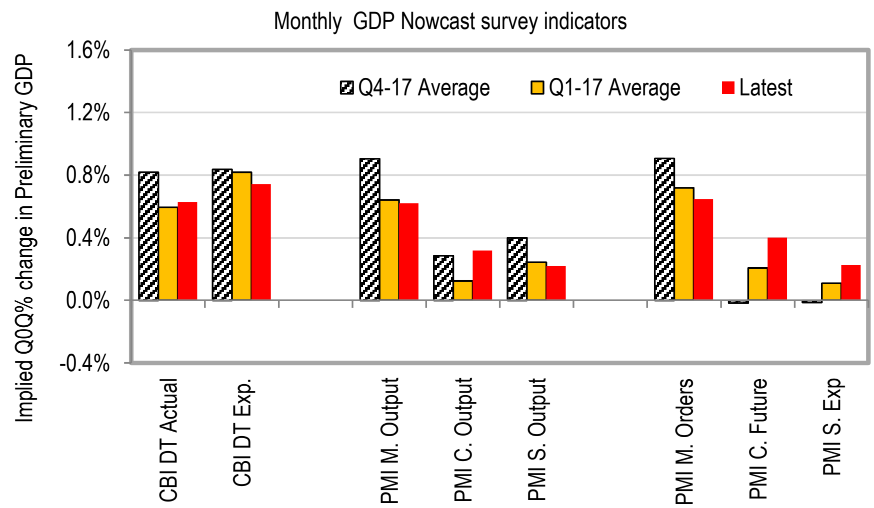
UK Monetary Policy: Residual hawkishness set to fade

Expectations around the near-term path of UK monetary policy have proved fluid in recent weeks, with the implied probability of an August rate hike falling from c95% in mid-April to just 30% currently. We continue to expect an unchanged monetary policy stance through both 2018 and 2019. But with market pricing still suggesting that a 2018 rate hike is more likely than not, a residual and durable hawkishness would still appear to exist across UK markets. In the sections below, we outline the five factors we see as most relevant for the UK monetary policy decision, and provide a summary of how we expect developments across each area to play out in the coming weeks;

1) **Q2-18 GDP growth likely to confound the MPC's optimism:**

With the Monetary Policy Committee (MPC) continuing to attribute the disappointing Q1-18 GDP figure (left unrevised by the second estimate at 0.1%) to weather effects, the degree to which the economy rebounds in Q2 should, inevitably, prove a key influence upon market sentiment in the coming weeks. Admittedly, the MPC's rhetoric on this issue appears to have shifted slightly in recent days. The Governor's comments before the UK Parliament's Treasury Select Committee acknowledged a 'residual' weakness in the Q1-18 GDP data (i.e. that not explained by poor weather) – largely relating to subdued consumer activity – while the risks of a 'disorderly' Brexit process were also discussed in the Governor's latest speech. But, with the detail of the May Inflation Report suggesting a 0.45% growth rate in Q2-18, we see this GDP figure as an obvious focal point for investors in the coming weeks, and one we believe is likely to be disappointed.

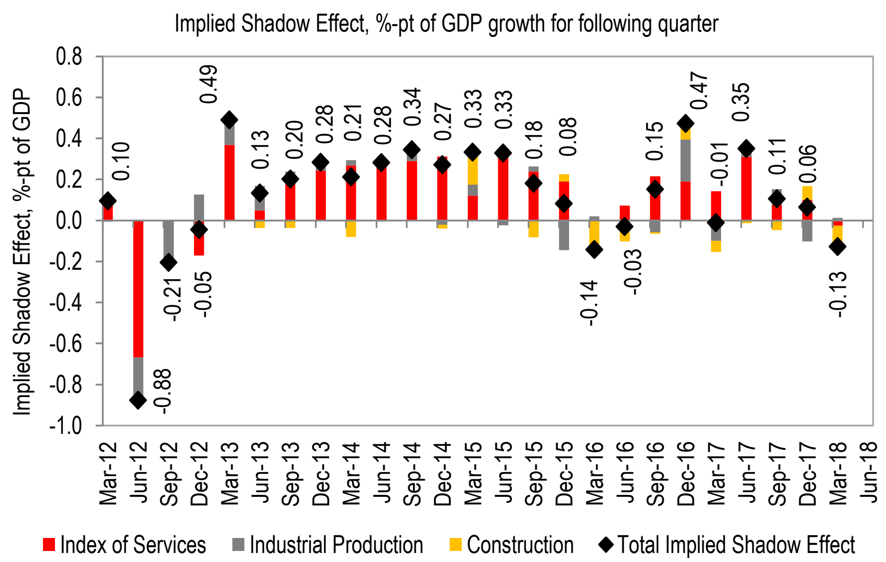
Chart 48: A 'Nowcast' measure based on key survey data suggests GDP growth of c0.2%



Source: IHS Markit, CBI, ONS, Santander.

Our caution around the prospects for Q2-18 GDP growth relate not just to the softer tone of recent survey data which, as Chart 48 illustrates, are now typically consistent with quarterly growth rates around the 0.2% mark, given the weak outturns for the dominant services sector. Rather, we remain concerned by the monthly profile of activity across the key sectors during the first quarter of the year, with the level of output in March (on a weighted-GDP basis) being below the Q1-18 average, thereby providing a weak (negative) start point for activity in Q2. As illustrated in Chart 49, we calculate that this implied 'shadow effect' is now at its most negative level since the beginning of Q2-16, and in the absence of any monthly or sequential growth in the second quarter, a contraction in GDP of 0.13%-pts would occur in Q2-18.

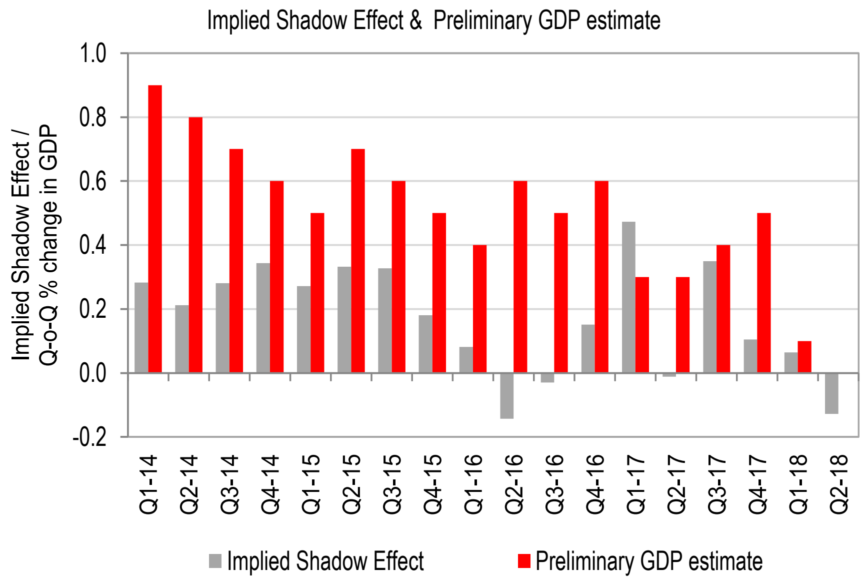
Chart 49: Implied GDP shadow effects, March 2012 to March 2018



Source: ONS, Santander.
Note: Chart shows the difference between the Inflation Report CPI projection for the first quarter of the MPC's forecast period (i.e. Q1-18 for the February 2018 Inflation Report) and the actual outturn. Data are shown so that a weaker-than-expected outturn is presented as a negative value.

Of course, a weak or strong shadow effect –as presented by the profile of the monthly output data during the previous quarter– is not the sole determinant of a quarter's growth prospects. As illustrated in Chart 50 – which compares the shadow effect surrounding each quarter since the start of 2014, and the actual preliminary estimate of GDP growth eventually returned for that quarter– weak starting positions for quarterly GDP growth in both Q2-16 and Q3-16 were eventually overcome, with healthy preliminary growth estimates being returned. But, with the various survey data having deteriorated since the beginning of 2018, we question the UK economy's ability to overcome the latest, weak starting point, and look for Q2-18 GDP growth closer to the 0.3% level, rather than the 0.45% expected by the Bank of England. Following on from the poor Q1-18 figure, we believe that such an outturn (0.3%) would lead policymakers to conclude that the economy is currently operating at a below-trend rate of expansion.

Chart 50: Implied shadow effect and eventual preliminary GDP estimates from Q1-14 onwards



Source: ONS, Thomson Reuters Datastream, Santander.

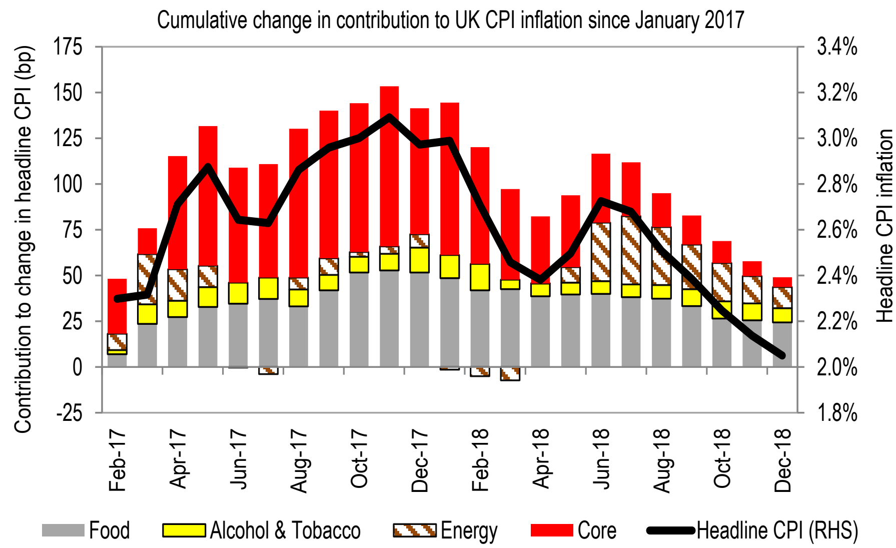
2) External support no longer a given:

As well as a narrow focus on the prospects for Q2-18 GDP growth, we believe that a broader appraisal of the outlook for external demand will also challenge the MPC's hawkish viewpoint in the coming weeks. Already, the May Inflation Report showed the Committee to have revised down its expectations around the contribution of net trade to UK GDP growth in 2018, to 0.25%-pts from 0.5%-pts in February, and we believe that this process may have further to run. Indeed, given Governor Carney's previous references to the concept of a global equilibrium policy rate, and how this had previously been seen to be rising, we believe that the less hawkish communications seen from a number of developed economy central banks in recent weeks may exert a subtle influence on UK monetary policy.

3) Core inflation to maintain a dovish tone:

We argue that the downward trend in headline CPI inflation in recent months – from a high of 3.1% in November 2017 to 2.4% in April – has been key in challenging market expectations around the MPC, particularly with inflation falling below the consensus expectation in each of the last three months. With this in mind, we believe that the inflation data for May and June could be of particular significance, given that we expect the headline CPI inflation rate to rise in both months – to a projected high of 2.7% in June - driven by the recent gains in petrol prices.

Chart 51: Bank of England Inflation Report CPI forecast errors



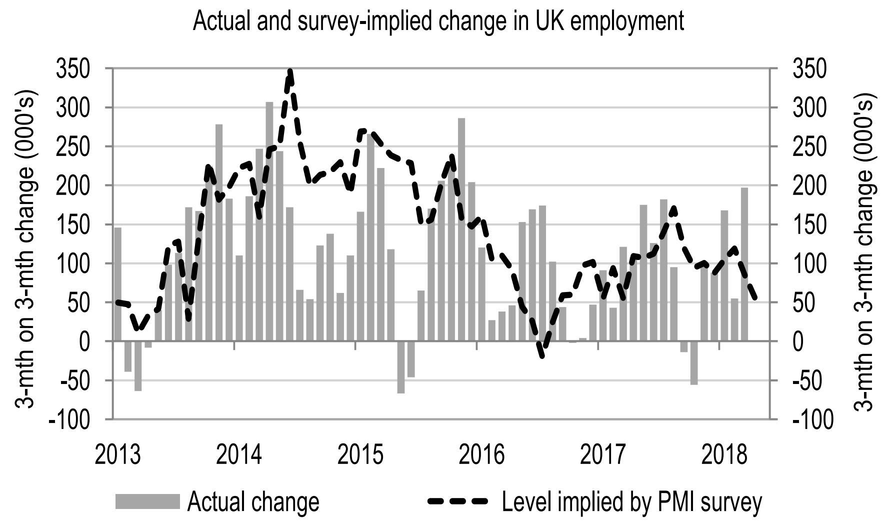
Source: Thomson Reuters Datastream, ONS, Santander.
Note: Chart shows the change in the headline rate of CPI inflation since January 2017 (CPI inflation of 1.82%), and the factors contributing to the change.

Critically, however, our forecasts call for a further decline in core CPI inflation over the coming months, remaining at the current 2.1% pace through to July, before ending 2018 at a 1.7% pace. As illustrated in Chart 51, our forecasts assume that any increase in CPI inflation in May and June 2018 will be driven entirely by energy prices, and would expect policymakers to 'look through' such a temporary acceleration in headline price growth. Indeed, we believe that the weakness of the more domestically-focussed areas of the CPI basket has received insufficient attention in recent months, with the April release showing a measure of core services CPI inflation falling to the lowest level since July 2015, and in fact within touching distance of the all-time low (1.92% in April 2018 versus 1.75% in November 2009).

4) **Labour data approaching a critical phase:**

Within a changeable economic environment, robust job creation has remained a key constant for the UK in the early months of 2018. Employment rose by 0.6% in Q1-18, leading to a 0.5% decline in productivity and reversing the progress made on this front in H2-17. We believe that the detail provided around the employment hints at potential sampling effects/bias, suggesting that a portion of the recent gains in job creation may have been exaggerated. But, even accounting for such potential distortions, job creation has still surprised to the upside, providing a crucial support to the Bank of England's hawkish bias.

Chart 52: Employment intentions appear to be in retreat



Source: IHS Markit PMI, ONS, Santander.
Note: Chart shows the 3-month on 3-month change in employment, and the level of employment growth implied by a GDP-weighted measure of the PMI survey employment intentions series.

However, we believe that a variety of indicators now point to a cooling of job creation during the remainder of 2018, albeit one still consistent with only a very modest increase in the headline rate of unemployment. Vacancies – although still close to the record level – have now fallen over the past three months, surveys of employment intentions are in retreat (see Chart 52) and, importantly, the pace of job creation over the past year has not been matched by a similar gain in the number of hours worked in the economy. In theory, this reduction in average hours worked may reflect labour market tightness, as the properties of the marginal labour supply evolve (less attached to the workforce). But with measures of involuntary part-time work also on the rise, we believe the trend points to a degree of spare capacity building across the corporate sector and, we argue, an imminent slowdown in job creation overall.

5) Potential Customs Union shift would not prove a panacea as deadline approaches:

As stated above, Mark Carney used his recent speech to discuss the risks to the UK economy from a disorderly Brexit, and highlight the scope for UK monetary policy to move in either direction over the coming year. But the one apparent certainty around the Article 50 process at present relates to the limited timescale in which to make a breakthrough in the Brexit negotiations, as the 29 March 2019 leave date comes into sharper focus. Almost inevitably, proposals to avoid a hard border from developing across Northern Ireland - whether versus the Republic of Ireland or alternatively to the remainder of the UK - remains the critical sticking point. Speculation of the UK remaining in the EU Customs Union – whether on a temporary or even permanent basis – has built in turn. But with the EU's preferred fall-back option effectively entailing Northern Ireland remaining part of the Single Market (as part of a common regulatory area for the island of Ireland), it is important to note that the gulf in negotiating positions stretches beyond the issue of customs arrangements. As such, even a major shift in customs proposals by the UK government may fail to secure a clear progression of negotiations ahead of the upcoming June EC Council meeting, increasing the uncertainties facing the UK economy as the period for negotiations declines.

UK Rates Strategy: De-risk in May and go away?

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- **Late May's risk-off stampede proved that gilts are still seen as a 'safe haven'**
- **Markets are now back to paying great attention to political risks…**
- **…which could prove acute in the UK as Brexit rows come to a head**
- **We consider opportunities in UK rates for a protracted risk-off spell**

Trade idea: Gilt 5s30s steepeners (2Q 23s/46s), outright or as an ASW box. We enter at a yield spread of 77bp, targeting 85bp, stop at 72bp.

Close trade idea: Buy UKT 2 20s vs. (Sonia) swaps from 21 May. This trade has flown through our target in this week's risk-off move, and we would take profits before risk sentiment has a chance to recover.

Close trade idea: 1s5s OIS steepeener. We revisited this idea on 18 May, resetting a tight stop of 48bp after hitting our original target, and the spread promptly fell back through that level. UK rates now look set for a longer wait for term premia to recover and we would not suggest re-entering this trade at present.

A nervous rally hit UK rates a little earlier than we expected

Our outlook for 2018 was for a bearish drift in global rates, with the UK tending to outperform as it became evident that the conditions for a BoE rate hike were unlikely to come together. On top of this broad-brush picture, we expected a sharp risk-off mood to hit the UK as a result of Brexit developments, including some combination of: economic deterioration, internal political disorder and/or a frustrated impasse with the EU27.

In the event, the market has indeed experienced such a rates-bullish shock, but triggered by Italian rather than British politics. UK rates ended May roughly where we forecast for the end of this quarter, although somewhat lower at the long end: as the trigger event for the rally was exogenous, long-term gilts did not acquire any credit risk premium which might have accompanied internal political stress.

May was supposed to be a crunch month (so as not to be confused with the PM) in the Brexit process, with key votes in Parliament on the Trade and Withdrawal bills and a need to progress negotiations with the EC before the European Council meeting in late June. Although the House of Lords, and a non-binding motion in the Commons, have advocated Customs Union and even EEA membership, the votes that could change the government's negotiating objectives (or, as some media outlets have speculated, the government itself) have been postponed to an unspecified future time. It has even been reported that the government may try to avoid a confrontation until the "meaningful" vote on the final exit deal, anticipated in the autumn, by which time it may be too late for MPs to turn the ship.

Market jitters may mount in the UK even if Italian risks fade

Even if the UK government manages to keep its internal and parliamentary conflicts from boiling over, the countdown to EU departure on 29 March 2019 continues inexorably. Sooner or later tough decisions must be taken, and the European Commission and disappointed groups faced up to – likely noisily.

There is a chance that markets manage to look through such noise and hold their nerve – as has largely been the case during the last eighteen months. Indeed, they had seemed to develop a much thicker skin for political distractions, barely flinching at events which might have caused serious price swings in previous years (the protracted German government formation, Catalan saga and outcome of the Italian elections). But the latest escalations of the Italian situation finally overwhelmed that stoicism, and may have increased market sensitivity to future political dramas.

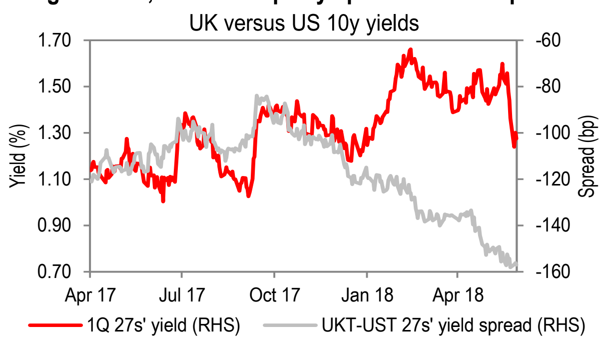
The rise of anti-EU(R) factions in Italy has also caused some commentators to suggest that the EU will become less accommodating in the Brexit negotiations, to further deter any countries considering a similar route. We would argue that the EC's stance has been transparently uncompromising from the start, and has shown no major divisions or softening of resolve. Italy may have done the UK government an inadvertent service if it has helped that message sink in, and dampened any hopes that the EC will suddenly become more generous on contentious topics this summer, albeit at the cost of making markets more aware of the same impending challenges.

Gilts set to outperform and steepen as economies diverge

The UK Economics section, above, explores key factors behind our dovish view on the BoE. They include concerns around the mounting uncertainty and risks around the Brexit process and more fundamental weaknesses in the UK's economy. Our cautious view on UK growth stands in contrast to our more upbeat macro outlooks for the Eurozone and, especially, the US, as detailed earlier in this document.

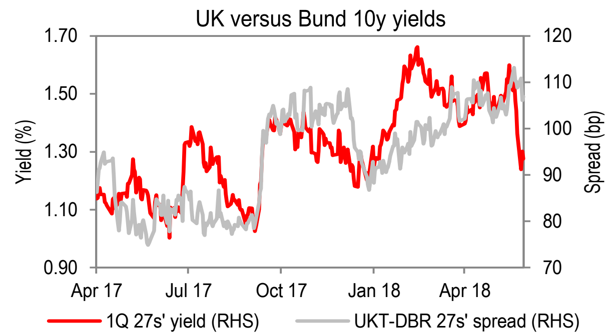
In central banking terms, this translates into the Fed's path to "normalized" rates remaining clear and the ECB ultimately being able to move away from such extremely accommodative policy settings over the next year, again in contrast to a BoE which could, conceivably, need to provide further liquidity or loosening over a similar horizon. The market has steadily trimmed its Bank Rate expectations over the last few weeks, but is still pricing for a hike by next May; we expect that prospect will be eroded further by data and events over coming weeks, casting a bullish shadow over longer-term UK rates.

Chart 53: Gilts have been steadily outperforming USTs (all across the curve) since October, regardless of gyrations in their outright levels, and a 160bp 10y spread need not prove a ceiling



Source: Bloomberg, Santander.

Chart 54: But gilt yields have managed to rise relative to Bunds throughout 2018, a trend which we do see as reaching its limits



Source: Bloomberg, Santander.

UK rates have been lagging ever-further behind the drift higher in US equivalents all year, and the sharp, Italy-inspired rally on both sides of the Atlantic did nothing to change that divergence (Chart 53). It is at a historical extreme, but that could have been said at most times since the end of 2016, and we see the widening as logical and sustainable given increasingly divergent economies and central bank stances.

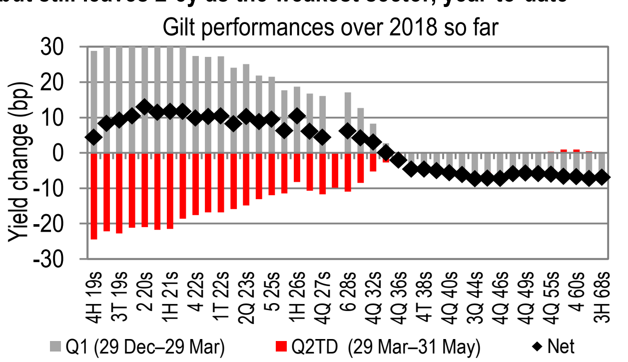
Despite the richening from a US perspective, gilts have in turn been trending wider over Bunds all this year, even after the market's recent reassessment of the BoE outlook (Chart 54). This can be attributed Bunds' scarcity, from the ECB's ongoing PSPP programme plus no new (net) German government borrowing, versus gilts' situation (no new BoE QE and a £41bn UK CGNCR). We still believe that the ECB will taper its QE by the end of this year, as described in the EUR Rates section, and that Bunds will finally be able to escape their 75bp ceiling as this prospect approaches – even as the UK economy's difficult position drives investors towards the perceived 'safety' of gilts.

Slower UK growth would imply additional government borrowing needs in such circumstances but, to the extent the OBR judges a slowdown to be structural, the Chancellor's fiscal rules and well-proven inclination towards cautious fiscal discipline should keep this under control. Overall, we expect the 'safe haven effect' (shown to still be firmly in place by the Italian panic) to outweigh any supply/credit premium and support gilts.

This net support would naturally be much stronger towards shorter maturities, and the very strong recent performance of long gilts could be more challenged in this scenario, which leads us to favour broad steepeners. Looking at how the yield curve has evolved so far this year, outright (Chart 55) and relative to historical daily betas (Chart 56), emphasises the relative value in the 5y and 30y areas. Although the short-run supply environment looks 30y-supportive, this already seems to be fully reflected in the price.

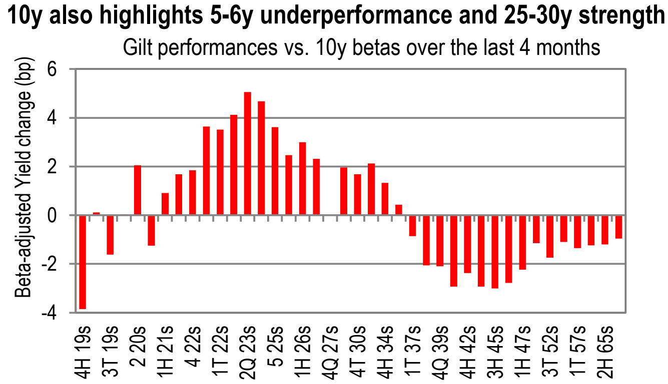
Although 30y yields are rather higher than 5y, both the carry and roll-down of these steepeners are positive (total 3.4bp over 3m, for the 2Q 23s/4Q 46s we see as the optimal RV choice). Simply buying the 5y, outright or on ASW, would be a more aggressive alternative, but we see that as unduly exposed to potential risk-on swings here, while the curve is very flat, full stop (Chart 57).

Chart 55: Two steps flatter, one step back: the latest bull-steepening has offset much of the pivot-flattening during Q1, but still leaves 2-5y as the weakest sector, year-to-date



Source: Bloomberg, Santander.

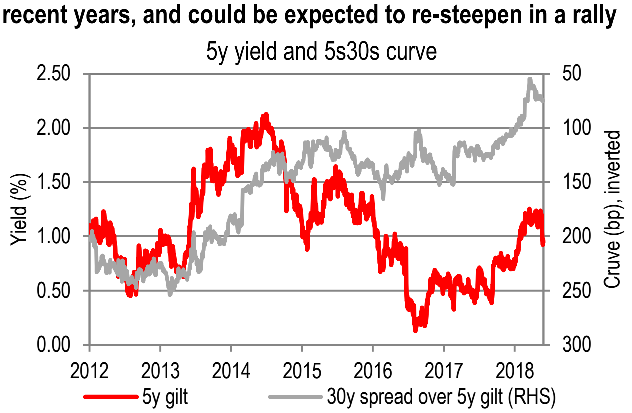
Chart 56: Adjusting gilt yield moves by their historical betas to 10y also highlights 5-6y underperformance and 25-30y strength



Source: Bloomberg, Santander. Betas calculated between daily changes over the 6 months to 9 May.

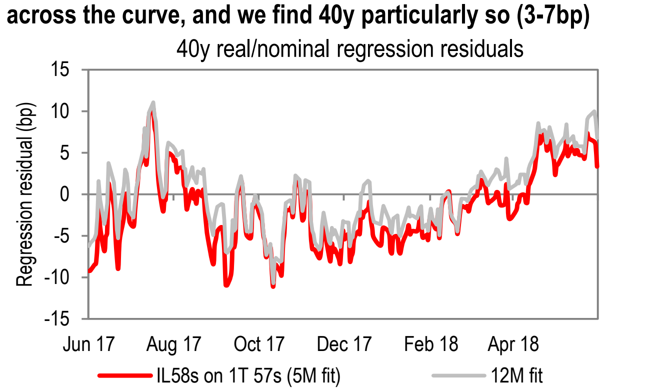
As a final observation, many of the implications of the heightened Brexit concerns we anticipate would be pro-inflationary: potential tariff and non-tariff trade costs, renewed weakness of the weaker pound and a central bank prioritising demand support over short-run inflation restraint. These could bring support for linkers, which have been under pressure in recent months (Chart 58). 40y breakevens remain our preferred sector.

Chart 57: The 5s30s curve remains extremely flat relative to recent years, and could be expected to re-steepen in a rally



Source: Bloomberg, Santander.

Chart 58: Linkers look cheap when regressed on nominals, all across the curve, and we find 40y particularly so (3-7bp)



Source: Bloomberg, Santander. Regression betas are 0.63 (5m) and 0.75 (12m), with R^2=58.1% and 65.8%.

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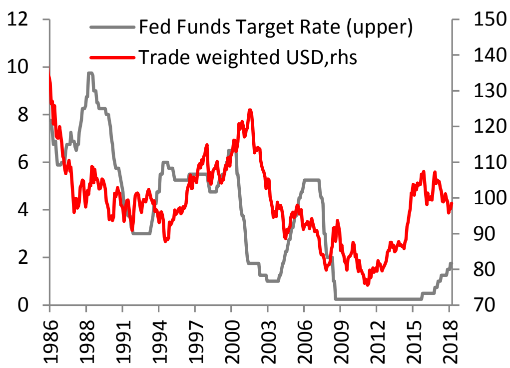
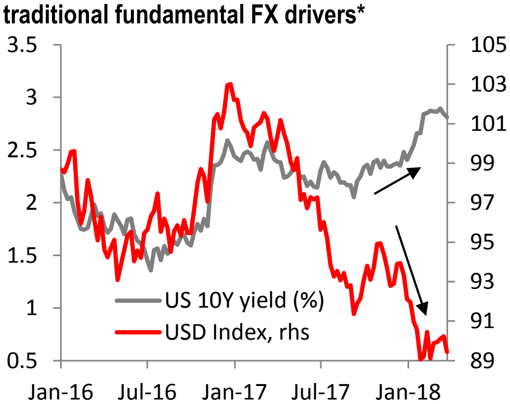
Taken from our latest FX Compass, published 24 May

Chart 59: Fed Funds and the trade weighted USD



Source: Bloomberg, Santander

Chart 60: The USD sell off from late 2017 to mid-April, indicated a divergence from some traditional fundamental FX drivers*



* As of 24 May 2018.
Source: Bloomberg, Santander

USD – Back to 2017

The USD has strengthened a lot over the last month. The currency looks to have recoupled with fundamentals and monetary policy/interest rate spreads. The perceived boost to risk appetite, focusing on North Korea and US trade tension with China, has also helped. But after strong gains, the currency may now find it harder to move even higher in the short term.

The USD has reversed all of its 2018 decline, with the USD index back at levels recorded in December 2017. We had suggested that the USD had been over sold since late 2017, as the market adopted far too negative a stance on it. An easing of this pessimism has helped the Greenback, but it has also been supported by specific factors affecting its most traded peers.

For example, the EUR has weakened amid renewed uncertainty about Eurozone/Italian politics. The Yen has weakened as risk appetite has improved and the market seems to have finally absorbed warnings from Japanese policymakers that there is no intention to end Japan's ultra-loose monetary policy any time soon. And, the Pound has tumbled as the BoE decided not to hike interest rates in May and Brexit concerns have re-emerged.

In addition, recently the dollar has also been bolstered by the apparent easing of trade tensions between the US and China. The market had been concerned that the implementation of US tariffs on China and other countries would spark retaliation and reduce global demand. Recall that the US wanted China to cut its trade surplus with the US by USD200bn by 2020.

Admittedly, some commentators are sceptical whether this trade truce will last. They suggest that the US reversal on these issues is due to lobbying to protect US exports to China and an effort to ensure that North Korean talks are not derailed by trade friction between the US and China. Hence, protectionism may become a USD negative issue again, but for now, at the very least, a 'trade war' appears to have been delayed.

However, the other FX issue here, is the USD's response to risk. Traditionally, the USD is viewed as a safe haven, but over the last year or so, low risk appetite has tended to prompt USD weakness with the market preferring the EUR and JPY. Thus, as US-China trade tensions have eased, the USD has strengthened, but it can be argued that the rise in risk appetite this implies, plus a more stable backdrop for global demand, should imply less need for the perceived safety of the USD.

We suspect that a large chunk of the dollar's recent rise is merely a correction to overselling late last year. The short USD trade may simply have been finally swamped by positive USD factors that had been present from late 2017 but were ignored. For example, the USD was sold aggressively even as the US economy was forecast to outperform in 2018, as the Fed hiked rates and interest rate spreads moved in the USD's favour.

Hence, in our opinion, the recent USD rally has merely corrected the misplaced USD selling. Momentum may propel the dollar even higher in the short-term, but we favour a more stable outlook, with a better global backdrop allowing other central banks, to end their loose monetary policies, and concern about the impact on US debt from tax changes to reassert itself.

EUR – Looking for support

The EUR has been under pressure over the last month. But we suspect that it may be drifting into oversold territory and retain our forecast profile that envisages gradual gains in EUR/USD into 2019. The re-emergence of political risk, focusing on Italy, has hit EUR sentiment, as has a revitalised USD. However, we are still positive on the Eurozone activity, and still expect the ECB to call time on its loose monetary policy from Q4-18, which should underpin the EUR.

Recall that the Italian general election was held on 4 March. The outcome was inconclusive, with no government formed. At the time, this uncertainty did not worry the FX market, perhaps because that might have implied a re-think of the negative USD stance that was dominant up to mid-April.

However, the formation of a new populist government, between the 5 star movement and the League has panicked markets. The Italian 10Y yield rose from 1.75% at the start of May, to 2.3%, with Italian equities losing 5% in May. The rhetoric from 5 Star/League has indicated a watering down of their market unfriendly negative stance on the EUR, but with the market more USD positive, Italian politics has become a stick with which, for now, to beat the EUR.

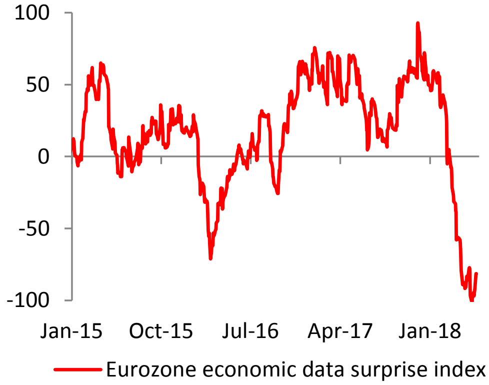
How long this will last is difficult to quantify, but we suspect that the currency may have drifted into oversold territory. Admittedly, speculators remain very long EUR/USD, despite reducing their positions over the last month, and this may imply further downside risks if this position is unwound further. But, assuming that the new Italian government at least brings some short-term stability, the EUR may find it easier to find some support over the coming month.

The Eurozone Q1-18 GDP data was weaker than expected. The economy grew 0.4% QoQ, but ECB President Draghi explained away the disappointing data as due to temporary factors. Further, the figure followed three quarters where growth was an impressive 0.7%. Certainly, economic data as a whole have tended to surprise to the downside in 2018, a factor that we highlighted in the last FX Compass as a reason that the EUR had been overbought.

But, whilst business confidence has slipped in recent months, overall, sentiment remains close to all-time highs and we still forecast robust Eurozone growth of 2.4% in 2018 and 2.2% in 2019. However, the EUR's gains in the early months of 2018, implied, in our opinion, that this good economic news had been priced in, with momentum and USD weakness then carrying EUR/USD into overbought territory, which has now reversed.

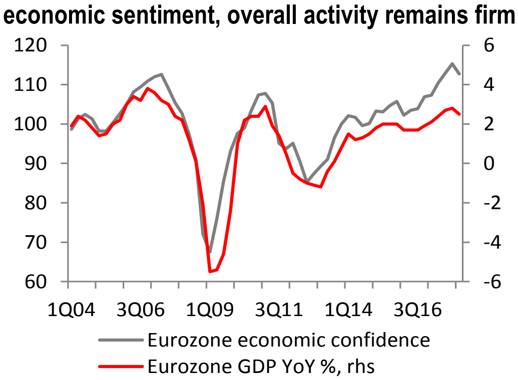
Similar to the Q1-18 GDP data, recent CPI figures have also surprised to the downside. In particular, core inflation slipped to 0.7% YoY in April, with headline inflation at 1.2% YoY. The decline should be temporary, although we still forecast headline CPI ending the year at a below-target 1.5% YoY. Hence, we still expect the ECB to stick to its plan to end its asset purchases in September, taper them in Q4-18 and raise interest rates at the end of H1-19. Given the market's current negative stance on Eurozone fundamentals and the EUR, as long as the bank clearly reiterates this intention over the coming months, ECB policy should, at the least, be able to offer the currency some support.

Chart 61: EUR on the back-foot as FX market finally acknowledges downside data surprises*…



*As of 24 May 2018
Source: Citi, Bloomberg, Santander

Chart 62: …but despite this, as well as a dip in economic sentiment, overall activity remains firm



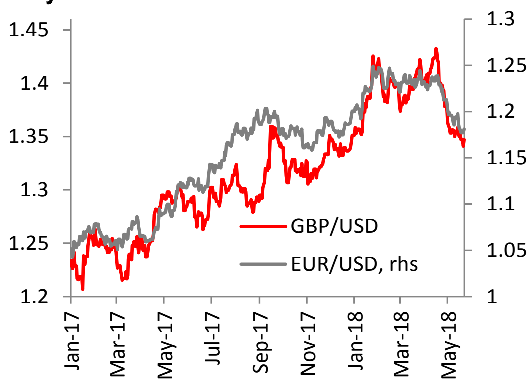
Source: Bloomberg, Santander

GBP – Taking a hit

Sterling has performed poorly since mid-April. Overall, we still see some downside pressure in GBP/USD and maintain our year end forecast for GBP/USD at 1.32. Since April, the market has woken up to UK economic data underperformance, the BoE's MPC kept rates unchanged at its May meeting, Brexit concerns have also weighed and the USD has strengthened across the board.

The Pound's performance between early March and 17 April was impressive. Over that period Sterling was the best-performing developed market currency. GBP/USD hit a high of 1.4377 on 17 April, returning to levels last seen at the time of the EU referendum in June 2016. But this advance, has more than reversed since mid-April, with GBP/USD down 6% to sub 1.35 levels, with Sterling the worst performer over that period.

Chart 63: GBP/USD is still primarily a dollar story*



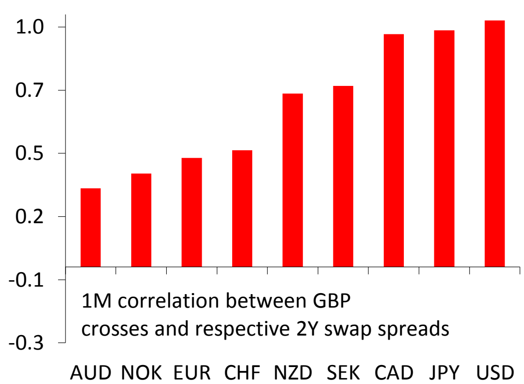
*As of 24 May 2018
Source: Bloomberg, Santander

Whilst UK-specific factors have added to the Pound's woes, a key ingredient in GBP/USD's decline has been the recovery in the USD, whilst Sterling has been more stable against the EUR. One risk is that a market that was too negative about the USD for several months, may now be over compensating for that error by being too positive and pulling GBP/USD lower too quickly. However, beyond the USD effect there are Sterling factors that should imply further Cable weakness and risks in 2018.

The UK economic outlook remains vulnerable. Overall, UK economic data have continued to surprise to the downside. The Q1-18 GDP data were much weaker than expected, with growth at 0.1% QoQ. Admittedly, the BoE blamed poor weather and expects a quick recovery in Q2. However, the Office for National Statistics seemed to take the opposite stance, downplaying the weather's role and seeing a real threat to activity.

On the plus side, the labour market remains strong, with unemployment at 4.2% and core average earnings rising by 2.9% in March. However, headline CPI has declined since reaching 3.1% YoY in November. We expect it to fall to the 2% target by the end of the year.

Chart 64: GBP correlation with spreads. If MPC defers hike, Sterling should tumble*.



*As of 24 May 2018
Source: Citi, Bloomberg, Santander

The BoE kept interest rates unchanged in May. The market had priced in a rate hike, after hawkish MPC rhetoric since February, but a change of tune by Carney from mid-April (helping start the Pound sell-off) made it clear that the Bank was unlikely to hike.

The MPC's optimistic belief that Q1's GDP disappointment will be short-lived, together with Carney's reiteration that rates are likely to go up in the next year, means that the market is pricing around a 50% chance of a rate hike at the August MPC. But, we believe that the BoE will keep policy unchanged through 2018 and 2019.

Given that GBP/G10 crosses are currently notably correlated with their respective rate spreads at both the short and long end of the curve, a reduction in rate hike expectations should encourage a further re-positioning. Indeed, the IMM non-commercial position data show that the net long GBP/USD position, which peaked in mid-April (as Cable reached its 2018 high) has now been completely unwound.

Finally, with Sterling sentiment more vulnerable, Brexit concerns may now pull the Pound lower. The market may become more negative if sufficient progress on talks between the UK and EU is not apparent at the EU Summit in Sofia on 28-29 June.

Table 4: G10 FX forecasts

	Q2 18	Q3 18	Q4 18	Q1 19	Q2 19	Q3 19
EUR-USD	1.22	1.24	1.26	1.24	1.26	1.28
GBP-USD	1.36	1.34	1.32	1.32	1.33	1.35
GBP-EUR	1.11	1.08	1.05	1.06	1.06	1.05
EUR-GBP	0.90	0.93	0.95	0.94	0.95	0.95
USD-JPY	116	117	118	120	122	120
EUR-JPY	142	145	149	149	154	154
USD-CNY	6.60	6.65	6.70	6.80	6.70	6.70
EUR-CHF	1.17	1.18	1.20	1.22	1.23	1.24
USD-CHF	0.96	0.95	0.95	1.00	0.99	0.98
EUR-SEK	9.5	9.3	9.0	8.8	8.6	8.6
EUR-NOK	9.5	9.4	9.3	9.1	9.0	8.8
USD-CAD	1.24	1.24	1.22	1.22	1.20	1.20
AUD-USD	0.76	0.76	0.77	0.79	0.80	0.79
NZD-USD	0.70	0.71	0.72	0.74	0.76	0.75

Source: Bloomberg, Santander

Euro interest rate forecasts

Government Bond yield Forecasts

Bunds	Current	3Q18	4Q18	1Q19	2Q19	3Q19
ECB Refi	**0.00**	0.00	**0.00**	0.00	0.10	0.25
ECB Depo	**-0.40**	-0.40	**-0.40**	-0.40	-0.40	-0.25
3m	**-0.59**	-0.70	**-0.60**	-0.55	-0.35	-0.20
2y	**-0.63**	-0.30	**-0.15**	-0.10	0.10	0.25
5y	**-0.22**	0.20	**0.35**	0.50	0.65	0.80
10y	**0.39**	0.80	**0.95**	1.15	1.30	1.40
30y	**1.09**	1.30	**1.50**	1.70	1.85	1.95

Swap rate forecasts

€ swaps	Current	3Q18	4Q18	1Q19	2Q19	3Q19
ECB Refi	**0.00**	0.00	**0.00**	0.00	0.10	0.25
ECB Depo	**-0.40**	-0.40	**-0.40**	-0.40	-0.40	-0.25
3m	**-0.32**	-0.33	**-0.33**	-0.29	-0.18	-0.02
2y	**-0.14**	0.10	**0.20**	0.25	0.40	0.55
5y	**0.32**	0.60	**0.75**	0.85	1.00	1.15
10y	**0.92**	1.20	**1.35**	1.50	1.65	1.75
30y	**1.50**	1.60	**1.75**	1.95	2.10	2.20

US interest rate forecasts

Government Bond yield Forecasts

USTs	Current	3Q18	4Q18	1Q19	2Q19	3Q19
FOMC (mid)	**1.625**	2.125	**2.125**	2.375	2.625	2.875
3m	**1.90**	2.00	**2.25**	2.50	2.75	3.00
2y	**2.49**	2.70	**2.85**	3.10	3.35	3.45
5y	**2.76**	3.00	**3.15**	3.40	3.60	3.70
10y	**2.91**	3.10	**3.25**	3.45	3.65	3.75
30y	**3.06**	3.25	**3.40**	3.60	3.75	3.85

Swap rate forecasts

$ swaps	Current	3Q18	4Q18	1Q19	2Q19	3Q19
FOMC (mid)	**1.625**	2.125	**2.125**	2.375	2.625	2.875
3m	**2.32**	2.40	**2.55**	2.70	2.85	3.05
2y	**2.74**	2.85	**2.90**	3.10	3.35	3.45
5y	**2.88**	3.00	**3.10**	3.35	3.50	3.60
10y	**2.95**	3.05	**3.15**	3.35	3.55	3.65
30y	**2.97**	3.10	**3.20**	3.35	3.50	3.60

UK Interest rate forecasts

Government Bond yield Forecasts

Gilts	Current	3Q18	4Q18	1Q19	2Q19	3Q19
MPC	**0.50**	0.50	**0.50**	0.50	0.50	0.50
3m	**0.49**	0.45	**0.40**	0.45	0.45	0.46
2y	**0.64**	0.40	**0.50**	0.50	0.55	0.60
5y	**1.00**	0.75	**0.90**	1.00	1.20	1.50
10y	**1.29**	1.20	**1.40**	1.60	1.80	1.90
30y	**1.75**	1.70	**1.80**	2.00	2.20	2.40

Swap rate forecasts

£ swaps	Current	3Q18	4Q18	1Q19	2Q19	3Q19
MPC	**0.50**	0.50	**0.50**	0.50	0.50	0.50
3m	**0.62**	0.65	**0.55**	0.55	0.55	0.56
2y	**0.97**	0.90	**0.95**	0.90	0.85	0.90
5y	**1.27**	1.10	**1.20**	1.25	1.40	1.70
10y	**1.51**	1.40	**1.50**	1.70	1.85	1.95
30y	**1.61**	1.30	**1.45**	1.80	1.90	2.10

FX forecasts

	Current	3Q18	4Q18	1Q19	2Q19	3Q19
EUR-USD	**1.168**	1.24	**1.26**	1.24	1.26	1.28
EUR-GBP	**0.877**	0.93	**0.95**	0.94	0.95	0.95
GBP-USD	**1.331**	1.34	**1.32**	1.32	1.33	1.35
USD-JPY	**109.6**	117	**118**	120	122	120
EUR-JPY	**128.0**	145	**149**	148.8	153.7	154

	Current	3Q18	4Q18	1Q19	2Q19	3Q19
NZD-USD	**0.70**	0.7	**0.7**	0.7	0.8	0.8
USD-CAD	**1.296**	1.24	**1.22**	1.22	1.20	1.20
AUD-USD	**0.75**	0.8	**0.8**	0.8	0.8	0.8
EUR-CHF	**1.157**	1.18	**1.20**	1.22	1.23	1.24
EUR-SEK	**10.31**	9.3	**9.0**	8.8	8.6	8.6
EUR-NOK	**9.54**	9.4	**9.3**	9.1	9.0	8.8

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

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

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

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