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Interest & Exchange

Transatlantic Monetary Policy Divergence

Global Strategy: Fuelled by a highly expansionary fiscal policy, the US macro performance is outpacing that of the euro area. This divergence also explains the differences in their respective monetary policies. However, we would warn against getting carried away by the thought of many rate hikes to come in the US or a long delay in the euro area's monetary policy normalisation.

US Macro: After the sharp deceleration in US personal consumption in 1Q18, we anticipate a clear rebound as soon as 2Q18E, supported by the favourable fundamentals related to the labour market, the fiscal reform, net worth and confidence. That said, the rise in inflation is a downward risk that limits the chances of household spending surprising positively.

US Rates: The increased hawkishness seen at the June FOMC will, in our view, put extra pressure on front-end rates in the short run; however, we start to question whether the Fed will be able to deliver as much as currently suggested by the dots for 2019. We are revising our forecasts, projecting higher rates and slightly flatter curves for the rest of 2018, but the end point for 2019 remains very similar. Trade ideas: pay the 2y2y and the belly in 2s5s30s.

EUR Macro: Euro zone inflation could average above 1.5% in 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, the latter also pressured by a more expensive energy.

EUR Rates: Italy concerns, ECB policy guidance and the general risk-off mood have pushed real EUR rates to levels that seem too low. While there is still considerable policy risk in Italy, SPGB fundamentals look quite firm and should fuel further outperformance.

GBP Macro: We believe that the communications provided at the June MPC meeting left more questions than answers with regard to the near-term policy outlook. We are concerned that the evolution of recent data releases appears to be playing only a minor role in the analysis of the Committee's most hawkish members. In our view, this questions the scope for market expectations to be formed predominantly by the strength or weakness of the various data releases, as the BoE expressly wishes. We remain of the view that Bank Rate will not be raised this year or next.

GBP Rates: We also explore another surprise from the MPC: a cut in the level of Bank Rate above which QE assets could be reduced. We find it to be a largely moot point. Regardless, the APF will be reinvesting £3bn in July, and we expect that unusually small holding to favour (recently underperforming) ultra-short gilts versus longer tenors. We find their ASW appealing (outright or as steepeners) and they should be largely insulated from BoE and political risks.

G-10 FX: The USD remains firm. A robust economy, rising CPI and rate hikes are providing support. But, will a protectionist US administration be prepared to allow the dollar to appreciate further? We have revised our EUR/USD forecasts lower but remain positive over the forecast horizon. We feel that the EUR weakened too much following the June ECB meeting. Plus, we remain upbeat about the Euro economic outlook. Sterling remains under pressure from a mix of poor data, Brexit uncertainty, and in our opinion a BoE that will not hike rates until 2020.

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

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Santander Corporate & Investment Banking

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	USD	EUR	GBP
Economic Outlook	We have revised our GDP estimates for 2018 up to 2.8% YoY (vs 2.5% bef.) and to 2.7% in 2019 (vs 2.6%) after including the effect of the fiscal reform. We forecast a higher fiscal deficit and a worsening of the current account positon.	We have slightly reduced our GDP estimate for 2018 to 2.3% (vs 2.4% bef.), 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	The Fed is increasingly likely to hike rates every quarter this year, but we believe it won't be able to raise rates as much as expected by the dot plot in 2019E.	It's now official: the ECB will continue buying bonds until Dec'18 but the first rate hike will not take place until Sep-2019.	We expect Bank Rate to remain at 0.5% through 2018E and no change in QE, with growth and inflation likely to fall short of MPC expectations.
Rates / Duration	The monetary policy normalisation, healthy macro environment and potential changes in the supply/demand equilibrium should weigh on USTs all along the curve.	EUR rates price in a lot of ECB restraint and risk-off sentiment. Assuming the recovery continues, current market pricing is a good entry point for the slow bond bearish trend.	Rates and pricing for a BoE hike by the end of this year still look too high, against a backdrop of heightened Brexit and economic uncertainty.
Curve / Slope	We remain bearish on the front end (pay 2y2y) but continue to prefer carry-efficient shorts in the belly (pay the belly in 2s5s30s).	Renewed belief in ECB dovishness has rewarded the 5y bucket, which now looks rich. Overall steepness remains highly directional.	UK curves remain unduly flat at all tenors. 10y has been a particularly strong performer so far this month, but 5y and 30y gilts have light supply ahead.
Spreads	Gradually unwinding SOMA reinvestments pose a risk for USTs. We like swap spread wideners (bearish USTs), especially at the ultra-long end.	Even with more focus on policy than politics, BTP spreads remain a volatile proposition. SPGBs' solid fundamentals underpin their underperformance.	Gilt spreads look set to remain wide in illiquid and unsettled summer markets. 5y offers most scope for further widening if stress increases.
Volatility	Ultra-long expiries, and the bottom right corner in particular, are now starting to look rich compared to recent ranges and also to delivered vol.	Realised vol has risen further, though with a limited knock-on effect on implied vol. If we are correct about higher rates into 3Q, there should be some catching up by implied vol.	Swaption implied volatilities have largely held on to their recent rises but remain remarkably sedate, especially towards longer expiries.
Inflation / Break-evens	After recent market volatility, front-end break-evens are clearly lower (as opposed to the rest of the curve), with no fundamental reasons for this move. We see a buying opportunity there.	Market-implied inflation is very close to fair value, given recent data, oil prices and overall directional momentum. The 5s10s ILS slope, however, looks too flat.	Petrol prices have paused the fall in CPI, but we still expect a move to the 2% target by year-end. Wage growth is still pivotal and underwhelming. 10-20y linkers look cheap.
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. We do not expect the BoE to hike rates.

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

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

	USD	EUR	GBP
Govies	**Sell the 30y UST in ASW** Entry level = 18bp. Target level = 30bp. Stop loss = 12bp	**1) Buy SPGB 0.35% Jul-23 vs. OBL 0% Apr-2023** at +73bp. Target +30bp. **2) RASW Schatz 0% Jun-2020** at E -49bp. Target E -40bp.	**1) Gilt 5s30s steepener.** at 75bp. Target = 85bp. Stop = 73bp. **2) 1s4s ASW steepener.** at -4bp, Target = +4bp. Stop = -6bp.
Rates	**1) Pay the belly in 2s5s30s** Entry = 2bp. Target = 6bp. 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** at -0.75%. Target -0.45% **2) Pay 2f2y Euribor fixed** at 0.40%. Target 0.60%	**1) GBP 5s10s steepener.** Current = 23bp. Target = 30bp. Stop Loss= 20bp. **2) Buy 10y (IL29s) gilt inflation breakeven, 70% beta-weighted.** Current = 265bp. Target = 271bp. Stop = 263bp.
FX	**Buy USD/JPY** original entry (Apr-18) at 109.30 target= 114, with a stop loss at 107.00	**Sell EUR/SEK** original entry (Apr-18) at 10.54. Target = 9.50. SL = 11.06.	**Sell GBP/USD** original entry at 1.4050, target= 1.3600, with a stop loss at 1.4200

Global Strategy: Transatlantic Monetary Policy Divergence

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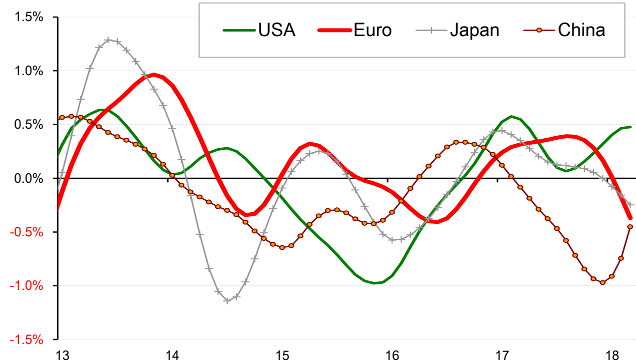
- **Fuelled by a highly expansionary fiscal policy, the US macro performance is outpacing that of the euro area. This divergence also explains the differences in their respective monetary policies. However, we would warn against getting carried away by the thought of many rate hikes to come in the US or a long delay in the euro area's monetary policy normalisation.**

Economic and Monetary Policy Divergence

The macro trends witnessed throughout most of this year remain in place. In the US, supported by the ***Tax Cuts & Jobs Act*** and its implications, the macro situation looks solid, with GDP expected to rebound after the seasonally poor first quarter. If the Bloomberg consensus is correct, and 2Q18 sees an acceleration in growth towards 3.4% (QoQ, saar), this quarter would be the strongest since 3Q14. Furthermore, the volatile Atlanta Fed GDP-Now growth forecast currently stands at 4.5% for 2Q18.

Accordingly, despite the weakness in some housing and real estate market indicators, related to the ongoing increase in short-term rates, other forward-looking macro indicators continue to perform strongly, especially those related to the labour market and business surveys.

Chart 1: OECD leading indicators for major economies (YoY)



Source: IMF, Santander

Chart 2: Actual and expected US GDP growth (consensus, %)

Source: Santander, Bloomberg

This macro strength is not so evident in the **euro area.** It seems that one-off factors were not the only culprits of pushing down 1Q18 growth (to 0.4% QoQ), as many of the second quarter forward-looking and real activity indicators have failed to register a noticeable increase in recent weeks.

Nevertheless, we believe that the recent performance should be put in context as despite the decline in the euro area's composite PMI to an 18-month low in May, it is still at a very healthy level of 54.8, consistent with 0.5% quarterly growth (Chart 3). That said, we will need to keep an eye on the performance of these indicators as the Euro Area Economic Surprise Index is showing a worrisome decline (Chart 4).

Chart 3: Euro area real GDP growth vs. composite PMI and EC Economic Sentiment

Source: Bloomberg, Santander

Chart 4: Euro, UK and US Economic Surprise Index

Source: IMF, Santander

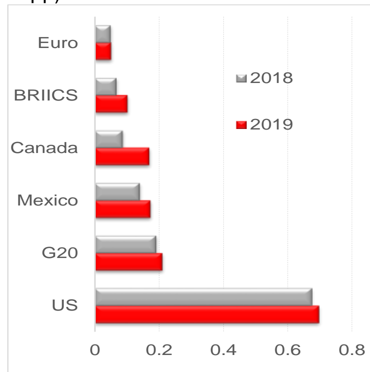
Transatlantic Monetary Policy Divergence

Given this scenario, the recent relatively hawkish tone of most Federal Reserve members should not come as a complete surprise. As neatly summarised by its chairman at the recent Sintra gathering, "with unemployment low and expected to decline further (and) inflation close to our objective…the case for continued gradual increases in the Federal Funds rate is strong".

It is hard to disagree, given the above-mentioned level of actual and expected growth. That said, as we have highlighted in the past, we would advise against getting too carried away by the current economic momentum in the US, as it is being boosted by a substantial tax reform (margin chart), and a significant portion of that growth and investment being brought forward to 2018 and 2019 might take US growth below its potential from 2020 onwards (the IMF recently lowered its US nominal GDP forecast for 2022 by 0.42%, to 3.2%).

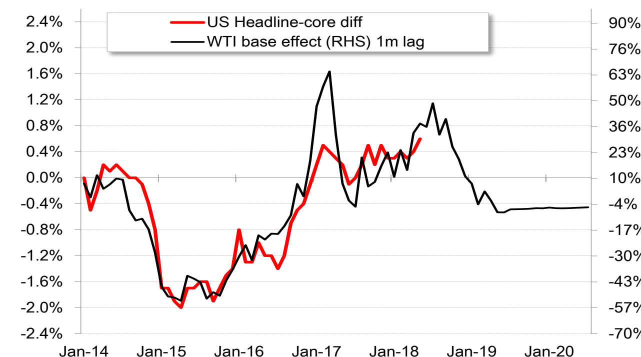
And in light of the expected acceleration in US CPI, not only due to solid demand but also to previous USD weakness and the rise in oil prices (Chart 6), if we add some wage acceleration, consistent with a below-NAIRU unemployment rate (Chart 7), the Fed might find it very difficult to assess the correct monetary policy stance.

Chart 5: Fiscal stimulus - Impact on GDP growth (difference from baseline, in pp)



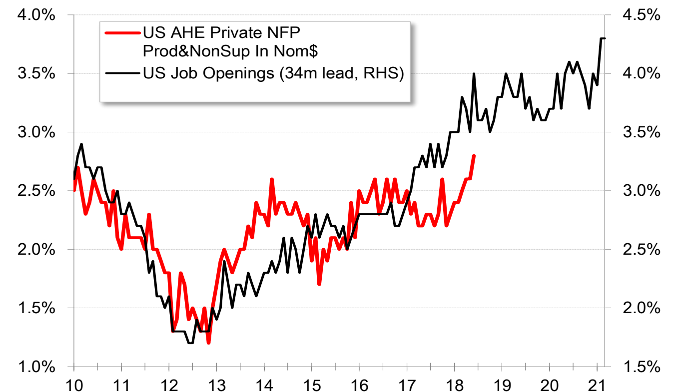
Source: OECD, Santander

Chart 6: Oil price performance will probably widen the US's headline-core inflation gap in the coming months



Source: OECD, Santander

Chart 7: US avg. hourly earnings vs. job openings; higher



Source: Bloomberg, Santander

Table 1: Extracts from the June FOMC statement, compared to 2 May

	Area	from:	to:
Macro	Econ. Activity	*moderate*	*solid*
	Unemployment	*stayed low*	*declined*
	household spending	*moderated*	*has picked up*
Mon Policy	Changes to FF	further gradual 'adjustments	increases
	Mon Policy	Remains accomodative	= (not fine-tuned)
	Fed Funds	.. to remain < long run levels	OFF

Source: US Federal Reserve, Santander

Frontloading growth...

In this complicated scenario, and given the relevance of US monetary policy for global financial markets and economies, we were more *comfortable* with the previous comments made by the Fed's chairman, recalling the symmetry of its inflation target, which seemed to imply that the Fed would not be overly concerned by (probable) inflation of above 2%.

That said, there were - by our count - at least six parts of the recent 13 June FOMC statement that sounded more hawkish than expected or compared to its communiqué released six weeks earlier. In a nutshell, the Fed sees the economy (activity, spending, etc.) as very robust, and did not provide any hint that monetary policy accommodation has diminished after seven hikes. Its members' Fed Funds expectations have also evolved accordingly.

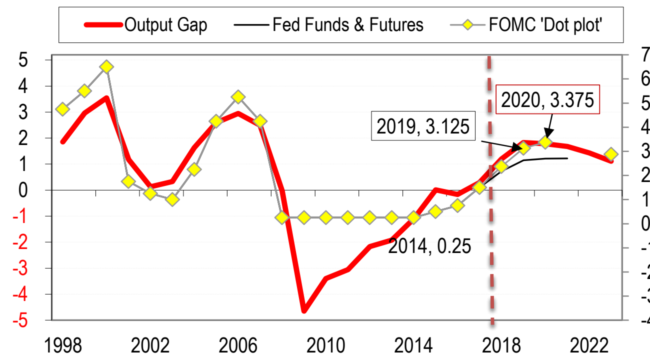
Looking at the official rates projections, although the market has apparently focused more on the fourth hike now expected (according to the median dot plot forecast) in 2018, **the additional hike now priced in for 2019, to 3.25%** (upper end of the range) **is more important, in our view**. Such level of Fed Funds would already be above what the Fed considers to be neutral, as its long-term expectations for the Fed Funds rate is 2.75-3.00%, which would take the whole UST curve above 3%, with the possibility of an inverted curve.

The FOMC therefore implicitly believes it will be running a restrictive monetary policy by the end of next year, turning even tighter by the end of 2020 (median dot plot forecast at 3.25-3.5%), at a time when the Fed's balance sheet will have shrunk by one-third, to c.$3trn, amid rising UST supply (the CBO expects the US annual budget deficit to stand at c.$1trn in 2019-2020).

…and monetary policy too?

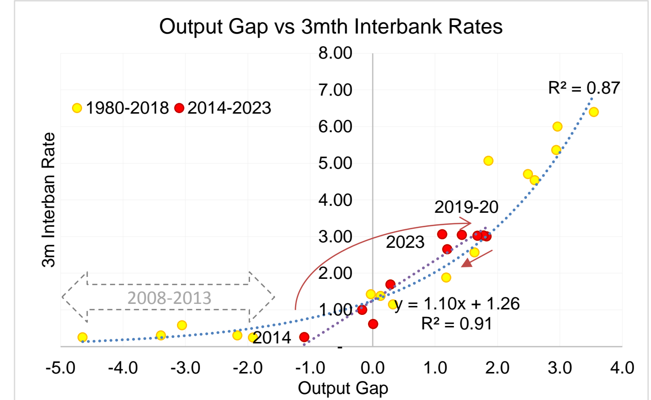
While the level of Fed Funds expected by the FOMC by the end of 2019 would seem consistent with the outperformance of US growth vs. its potential (Chart 8), the subsequent deceleration in 2020-2023 would then be consistent with an easier monetary policy; 75bp lower short-term rates given their relationship (Chart 9). However, trying to accommodate official rates to this up-and-downs seems unnecessarily risky to us given the implications of higher US rates, not only for global financial markets, but for financing the huge and growing public debt pile at a rising cost. We would add that although a US recession does not seem probable in the near future, should it became likely, **the Fed's room for manoeuver will be limited on the monetary policy side, but non-existent on the fiscal side**. And we do not dare to factor in a possible escalation of the global trade/tariff war that will be negative for all countries. Consequently, we do not share the Fed's views about the need to take the official rate above 3%.

Chart 8: US output gap (+ IMF forecasts) vs. 3M interbank rates (+ forwards, RHS)



Source: Bloomberg, Santander, IMF

Chart 9: … and regressed: Output gap = 77bp vs. US 3M

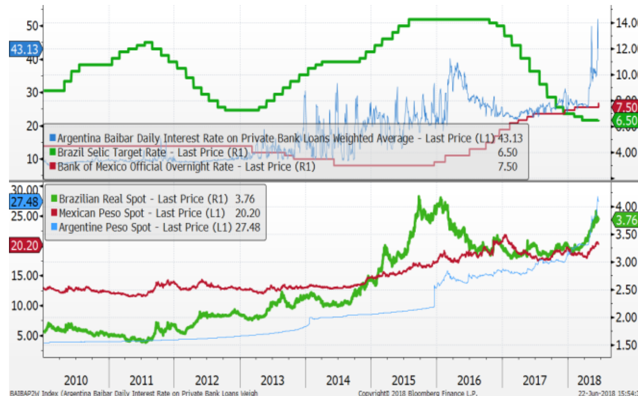


Source: Bloomberg, Santander, IMF

Can't stop me now

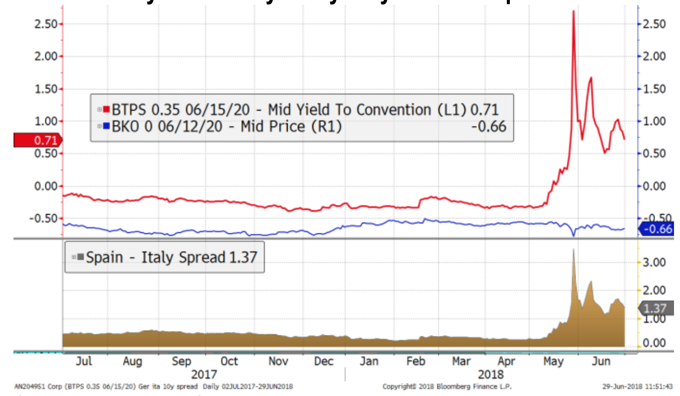
The final piece of the puzzle when assessing the US monetary policy outlook is the international environment. In other words, given this healthy domestic macro and financial backdrop, we wonder what would have to happen overseas for the Fed to make a pause in its current hiking pattern. Despite the large number and relevance of existing uncertainties (Euro politics, Brexit, EM macro and political uncertainty, trade-tariff war escalation, etc.), barring a significant further deterioration, we doubt that these concerns will be enough to justify altering the Fed's one-quarter-per-quarter hiking pattern for the rest of this year. We think that the most likely outcome is for the Fed to hike four times in 2018, i.e. two further rises in September and December (similar to the FOMC's median dot plot forecast), but followed by only two more hikes in 2019 (vs. three expected by the Fed) and no further moves in 2020 (vs. two expected by the Fed). Given the asymmetrical risks, we see no benefit in taking official rates beyond their 'neutral' level and we expect the Fed to pause 75bp below its own projection.

Chart 10: Main Latam official rates and currencies



Source: Bloomberg, Santander

Chart 11: Italy – Germany two-year yields and spread



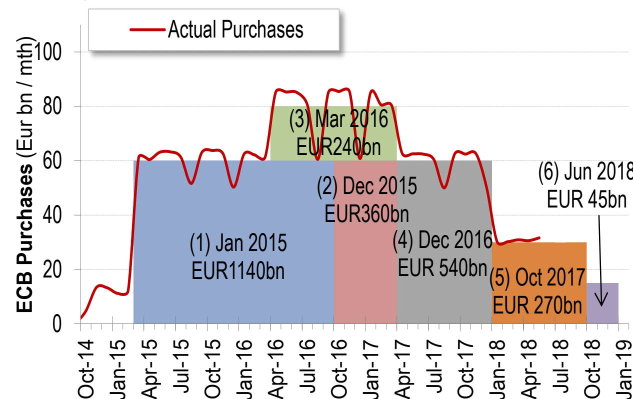
Source: Bloomberg, Santander

ECB APP: That's all, folks!

As regards the ECB, the monetary policy outlook now seems much clearer, both in conventional and non-conventional terms. Probably in an attempt to avoid any political interference - or interpretation of its decisions - the ECB decided to end the speculation and at its June meeting already provided basically all the remaining details about the end of its QE programme. Accordingly, and largely as we expected, after the already known €30bn monthly purchases until September, the ECB will continue buying bonds, at half that pace, until year-end, when its purchases will come to a halt.

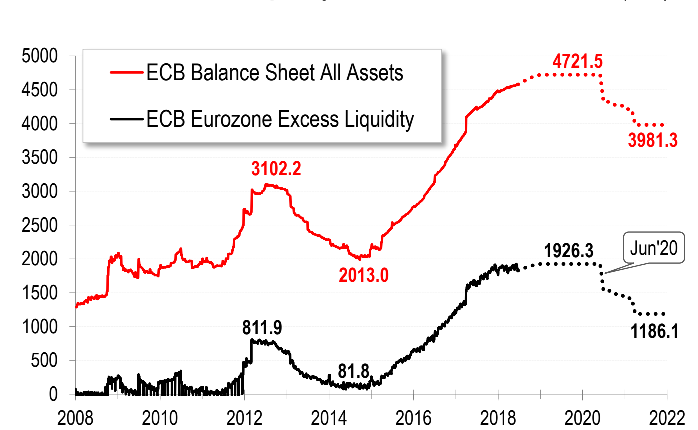
And that will probably be the end of its Asset Purchase Programme, which will total c.€2.6trn, more than twice its €1.14trn initial estimate (Chart 12). The ECB also made clear that it will keep this chunky portfolio "for an extended period of time after the end of the asset purchases", with c.€200bn being reinvested annually across the different curves. Its 'duration' impact will continue helping these markets and should prevent sharp increases in rates and spreads.

Chart 12: ECB asset purchases + announcements and monthly pace



Source: Bloomberg, Santander

Chart 13: Euro excess liquidity + balance sheet + forecast (€bn)



Source: Bloomberg, Santander

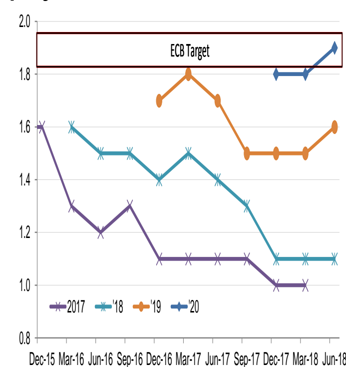
ECB watchers' sabbatical

(*) "and in any case for as long as necessary to ensure that the evolution of inflation remains aligned with the current expectations of a sustained adjustment path".

The conventional monetary policy side is unlikely to bring many surprises in the short term either. In its attempt to continue shifting the market focus to official rates - and its forward guidance - from bond purchases, the ECB recently stated that official rates should remain "unchanged at least through the summer of 2019 (*)".

This came as no surprise either, and was in line with our expectations of, at least, another year with unchanged rates. Hence, the only possible debate for a while will be the pace of rate hikes, once the ECB starts moving in, at least, over a year from now.

Chart 14: ECB Core inflation projections



Source: Bloomberg, Santander

Given our relatively sanguine view of the euro economy, with nominal GDP having been growing around 4% for a relatively long period before next summer, unless the EUR exchange rate is extremely strong, the global economy decelerates much faster than expected or financial markets suffer a very severe correction, we think that by next summer the ECB will be willing to start gradually taking its deposit rate back to at least zero per cent. And with excess liquidity remaining above €1.5trn until at least mid-2020 (Chart 13), most EUR short-term rates (EONIA and Euribor) will remain closer to the depo rather than the refinancing rate, limiting any monetary tightening.

Accordingly, with an eye on oil prices and potential surprises from wages on the one hand but political risks (inside and outside the EU) and rising global protectionism on the other, we maintain our call for the deposit rate at zero by the end of 2019 with a refinancing rate around 50bp at that time. At the end of the day, the ECB now expects headline inflation to be c.1.7% for 2018, 2019 and 2020. Time-wise, it therefore seems that Mr. Draghi will be able to kick off the – gradual – monetary hiking cycle before his term expires in 4Q19.

US Economic Outlook

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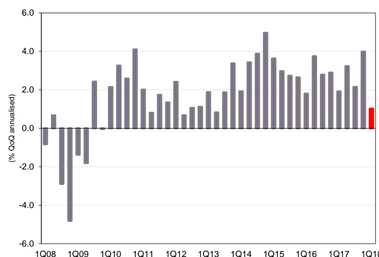
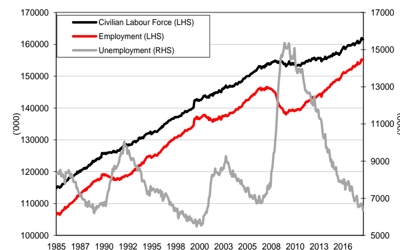
After the sharp deceleration in US personal consumption in 1Q18, we anticipate a clear rebound as soon as 2Q18E, supported by the favourable fundamentals related to the labour market, the fiscal reform, net worth and confidence. That said, the rise in inflation is a downward risk that limits the chances of household spending surprising positively.

Chart 15: Personal consumption



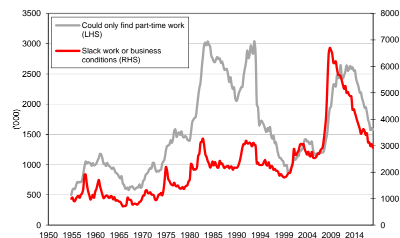
Source: BEA, Santander.

Chart 16: Labour market



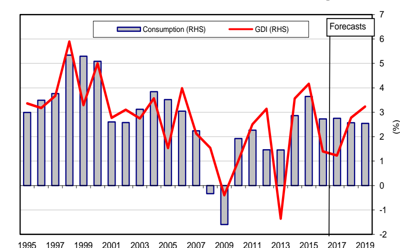
Source: BLS, Santander.

Chart 17: Slack in the labour market



Source: Datastream, Santander.

Chart 18: Revenues & consumption



Source: Datastream, Santander.

The beginning of this year turned out to be quite modest in terms of GDP growth: 2.2% annualized in 1Q18 from 2.9% in 4Q17. Behind this deceleration was a severe loss of traction in personal consumption, at 1.0% annualized from 4.0% in 4Q17, particularly in the goods segment (-0.6% annualized in 1Q18 from 7.8% in 4Q17). Far from being worrying, we continue to think the fundamentals are very conducive to an acceleration in US household spending as soon as 2Q18E

The labour market adjustment is almost complete

The unemployment rate has been falling sharply (at 3.8% in May18 from an average of 4.4% in 2017), and job creation remains strong (1.6% YTD). In 'normal' economic cycles, this would mean a tight labour market. The still low labour participation ratios change this view. Total unemployment continues to fall and is at close to its lowest level since 2001, and the participation rate remains stable (62.7% in May18, in line with the average of the last two years). That said, the participation rate is still clearly too low by historical standards, but the total unemployment level is comfortably below the peak of previous recessions (2003 and 1992). Job distribution by sectors means the services sector is leading the recovery, while the goods-producing sector is still very weak, although gradually recovering. In terms of earnings per hour, we have seen an acceleration in the pace of growth in the goods sector and stable growth in services while growth in the services sector is too low versus previous cycles. Regarding activity levels, we expect an acceleration in hours worked in the goods-producing sector and relatively stable numbers in services in the coming months.

All in all, we expect: (1) unemployment to fall to an average of 4.0% in 2018E (vs 4.4% in 2017 and 4.9% in 2016); (2) the civilian labour force to grow by 1.2% in 2018E (0.7% in 2017); (3) employment to grow by 1.6% in 2018E (1.3% in 2017); and (4) average hourly earnings to rise 2.6% in 2018E from 2.3% in 2017.

Fiscal reform supports income

Personal income grew by 3.1% in 2017 (2.4% in 2016), and we expect an acceleration in 2018E (4.2%) and 2019E (4.8%). Wages and salaries, supported by employment and stronger growth in salaries per employee or per hour, should be the main driver of the increase in personal income (5.3% in 2018E and 5.7% in 2019E from 3.3% in 2017). We have slightly reduced our tax estimates for 2018E-19E, incorporating the new fiscal package, and raised our estimates of the PC deflator growth rates (on the back of higher energy prices). As a result, real gross disposable income could grow by 2.8% in 2018E from 1.2% in 2017 and accelerate again in 2019E (3.2%). We estimate that average hourly earnings are likely to expand by 2.6% in 2018E and 2.9% in 2019E, from 2.3% in 2017.

We forecast that the income growth rates should be more than enough to maintain consumption growth at 2.5%-3.0%. We expect some sort of recovery in the savings rate, as it has deteriorated significantly in recent years.

Net worth and debt service are still bolstering consumption

Households' net wealth continued to grow sharply to US$98.746trn in 2017 from US$91.583trn in 2016. This is a record level in both absolute terms and in relation to gross disposable income (6.8x GDI in 2017) and gives ample support to the sustainability of private consumption.

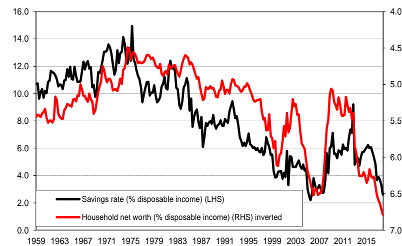
The recovery in households' net wealth position is now coming only from the assets side, thanks to the flow of savings and, even more, the appreciation

of assets on the balance sheet. On the liabilities side, households are increasing debt levels again in absolute terms (up 4.0% but down to 79.2% of GDP in 2017), mainly via consumer credit (5.4%; 19.4% GDP), with the stock of mortgage debt up by 3.0% (51.1% of GDP).

On the assets side, there was again good news from tangible fixed assets (real estate is up 6.5% to US$27.848trn, the highest level ever), consumer durables (up 4.9% at US$5.652trn, also the highest level ever) and financial assets (up 7.7% at US$80.995trn), and we highlight corporate equities (+17.5% and US$17.877trn), mutual fund shares (19.8% and US$8.685bn) and pension fund reserves (6.4% and US$23.223trn). We expect net wealth to continue rising in 2018E.

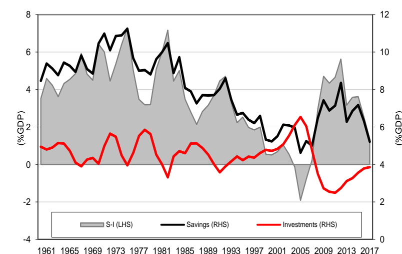
All in all, the performance of the households' balance sheet has been very good so far, with net wealth indicators still improving and total debt service ratios remaining stable in a scenario of accelerating consumer credit (consumer credit service has gone up, entering in a relatively high range from an historical perspective). However, mortgages are still very supportive.

Chart 19: Households' wealth and savings



Source: NPA, Datastream, Santander.

Chart 20: Households' savings and investment



Source: Datastream, Santander.

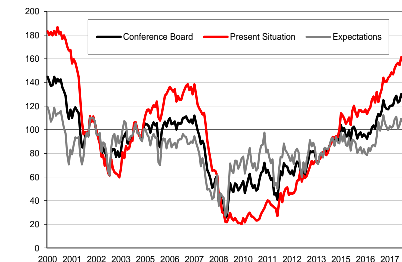
Main risks for personal consumption

As a result, households' confidence has improved rapidly, returning to the levels seen in 2001, mainly thanks to the optimism maintained in anticipation of lower unemployment rates in the coming months and the tax cuts. In other words, we consider that households' encouraging expectations could mean upside risk for their spending in the coming quarters.

Conversely, we see a clear downward risk for personal consumption in the evolution of inflation. We believe inflation is likely to rise, driven by base effects on oil prices and Mr Trump's economic policy.

While oil prices supported private consumption in recent years, they could basically do the opposite in the coming months. That said, we do not think the current pick-up in oil prices will reduce consumer spending growth. In other words, the rise in energy bills should not have a very negative impact on consumption. In fact, energy consumption as a percentage of current GDI levels is still relatively low, while income continues to grow. The increase in other prices is what has been limiting growth in real income so far and could continue to do so in the short run. Some transitory factors are now turning around and again pushing core inflation upwards. We expect the headline CPI to stand at an average of 2.5% in 2018E (2.1% in 2017) and the core index at 2.0% (from 1.8% in 2017). We believe that the risks for prices are more on the upside than on the downside.

Chart 21: Consumers Confidence



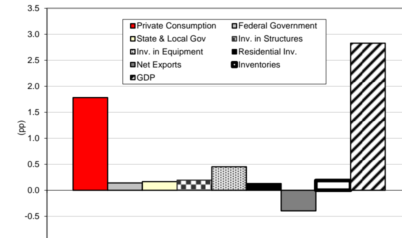
Source: Conference Board, Santander.

Conclusions

The bulk of the indicators already released regarding the performance of private consumption (confidence, personal income and spending, retail sales, etc.) point to an acceleration towards 3.0% annualized in 2Q18E, contributing very clearly to a higher expansion of overall GDP in the quarter.

For the whole of 2018E, we could see US private consumption at 2.6%, moderating slightly to 2.5% in 2019E (at 2.8% in 2017). That said, it should continue contributing very significantly to the GDP expansion but, absent a significant increase in hourly earnings growth, we believe it is difficult to expect a sharp acceleration in personal consumption going forward mainly due to higher inflation.

Chart 22: GDP breakdown in 2018E



Source: Datastream, Santander.

US Rates Strategy: “normalisation” vs. “tightening”

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- **The increased hawkishness seen at the June FOMC will, in our view, put extra pressure on front-end rates in the short run. A total of four hikes in 2018 seems the base-line scenario now, but we start to question whether the Fed will be able to deliver as much as currently suggested by the dots for 2019. We are lifting our forecasts, projecting gradually higher rates and slightly flatter curves for the rest of 2018, but the end point for 2019 remains very similar.**

Table 2: Our forecasts for US rates

USTs yields	3Q18	4Q18	1Q19	2Q19	3Q19	4Q19
Fed Funds	2.125	**2.375**	2.625	2.875	2.875	**2.875**
3m	2.15	**2.40**	2.65	2.90	3.00	**3.10**
6m	2.38	**2.60**	2.85	3.05	3.15	**3.25**
12m	2.60	**2.80**	3.05	3.20	3.30	**3.40**
2y	2.80	**3.05**	3.25	3.40	3.50	**3.60**
5y	2.95	**3.20**	3.45	3.60	3.65	**3.70**
10y	3.05	**3.25**	3.45	3.60	3.70	**3.80**
30y	3.15	**3.30**	3.45	3.55	3.60	**3.65**
USD swaps	3Q18	**4Q18**	1Q19	2Q19	3Q19	**4Q19**
Fed Funds	2.125	**2.375**	2.625	2.875	2.875	**2.875**
3m	2.55	**2.75**	2.95	3.15	3.20	**3.25**
6m	2.78	**2.95**	3.15	3.30	3.35	**3.40**
12m	3.00	**3.15**	3.35	3.40	3.40	**3.50**
2y	3.05	**3.25**	3.40	3.50	3.55	**3.60**
5y	3.05	**3.25**	3.45	3.55	3.55	**3.60**
10y	3.05	**3.20**	3.40	3.50	3.60	**3.70**
30y	3.05	**3.20**	3.35	3.40	3.45	**3.50**

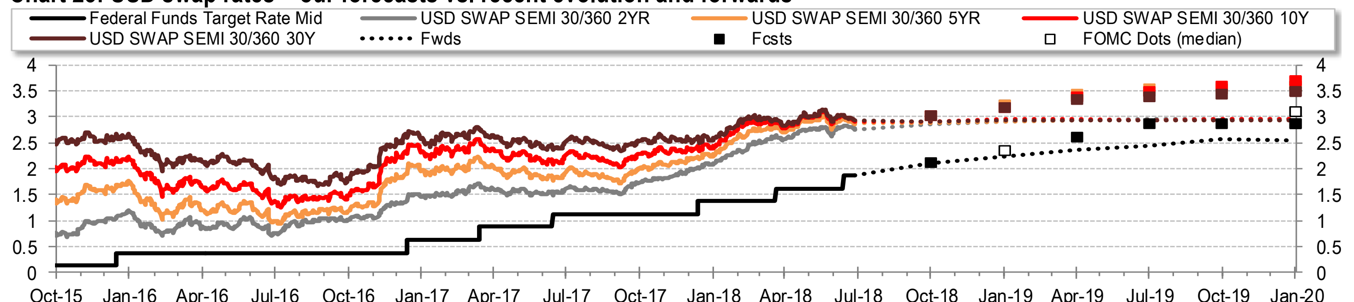
Source: Bloomberg, Santander.

The Fed foresees higher rates in 2018 AND 2019. We are a little more sceptical about next year

The Fed surprised with a more-hawkish-than-expected message at its latest FOMC meeting (see our post-mortem analysis in the 14 June MMD). The updated dot plot included upward revisions not only to the 2018 median, but also to the 2019 median. If this translated into actual hikes in coming quarters, it would mean that the Fed would already be taking official rates higher than what they consider appropriate for the longer run (i.e. a good proxy for the “neutral” rate) already next year. While we agree that a fourth hike this year seems the most likely scenario now (and we are changing our forecasts to incorporate that fourth hike this year), we tend to think that this extra hike in 2018 would essentially bring forward one of those already planned for 2019, rather than adding to those already envisaged for the next 18 months. Consequently, we think that the FF rate could end this year at 2.25-2.50% as suggested by the dot plot, but then it would finish 2019 at 2.75-3.00% (25bp lower than the current 2019 median in the dot plot), as we think it is still premature to assume that the US economy will need the Fed to switch from “normalisation” to “tightening” mode when it comes to monetary policy in 2019. See the Global section for a wider discussion of this matter.

As shown in Table 2, we are updating our forecasts to incorporate a fourth FF hike in 2019 but still maintain our FF projection for 4Q19. As a consequence, we are lifting our projections for the front end of the US curve in the next few quarters (although the end point in 4Q19 remains unchanged). In the case of the belly and the long end, we think that if the Fed accelerates the pace of hikes in 2018 but then needs to stop in 2019, it might lead the market to think that the chances of having official rates significantly higher than the neutral rate (or the longer-run dot) would be lower, and therefore it could even slightly limit the possible increase in the belly and the long end of the US curve during 2019. As shown in Chart 23, our forecasts, albeit slightly less hawkish than what the current dot plot would imply for 2019, are clearly higher than current forward rates and, as a result, continue to express a bearish view on US rates.

Chart 23: USD swap rates – our forecasts vs. recent evolution and forwards



Source: Bloomberg, Santander.

UST curve flattening / inversion. Not such a big deal for the Fed, after all…

Table 3: Our forecasts for the US curve

USTs yields	3Q18	4Q18	1Q19	2Q19	3Q19	4Q19
2s5s	15	15	20	20	15	10
5s10s	10	5	0	0	5	10
2s10s	25	20	20	20	20	20
10s30s	10	5	0	-5	-10	-15
2s5s10s	3	5	10	10	5	0
2s10s30s	8	8	10	13	15	18

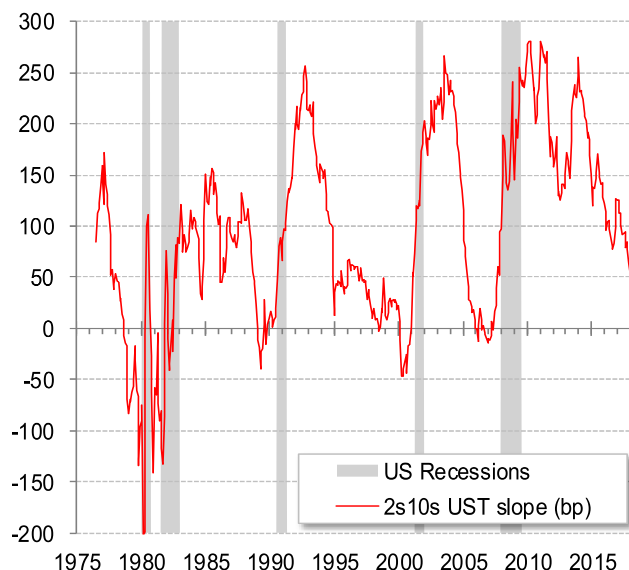
Source: Bloomberg, Santander.

If we were asked to choose one single theme that surprised us in the latest FOMC, the lack of focus on the ongoing flattening of the US curve would immediately spring to mind. As we explained in detail in our FOMC preview, included in the 12 June MMD, we had seen increasing concern about this issue in the past few FOMC minutes, and while we do not see current slope levels close to anticipating an imminent end to the expansionary cycle, we thought that the Fed might feel tempted to moderate its message (by introducing a more dovish turn in its forward guidance) to avoid adding to the ongoing market movement.

In contrast, the shift in forward guidance was to the hawkish side, which in our view increases the risk of further flattening of the curve, especially in the next couple of quarters. While we expected the FOMC minutes to reflect that discussion (and concerns), it seems that, for the time being, the Fed is nowhere near to altering its monetary policy stance just on the back of this flattening. Hence, we are incorporating the risk of even flatter US curves in our forecasts, as shown in Table 3. In fact, if the Fed finally goes ahead with hiking as much as suggested by the dot plot in 2018 AND in 2019, there would be a risk of curves being even flatter than in our forecasts, which have been calculated on the basis of a less aggressive Fed in 2019.

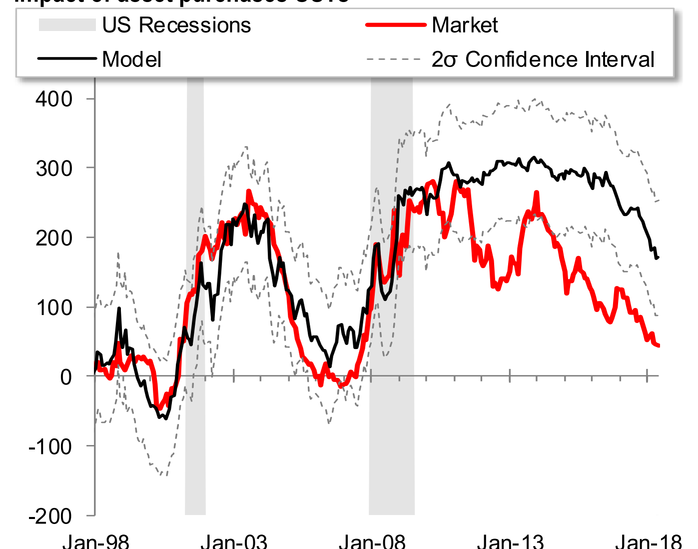
As we discussed in detail in our FOMC preview, included in the 12 June MMD, while a flat/inverted UST curve has historically preceded US recessions in the past (see Chart 24), we think that the current slope of the curve is affected by the reduction in term premia caused by asset purchases and, therefore, its relationship with macro expectations is different now. If we take fundamental models that successfully explained the evolution of the 2y and the 10y UST yields before QE (based on GDP, CPI and monetary policy expectations) and compare the 2s10s slope that these models suggest vs. the actual 2s10s slope seen in the market, they all tend to show that, according to historical standards, the current slope is significantly flatter than it should be, given the current macro and monetary policy (see Chart 25).

Chart 24: 2s10s slope in USTs (bp) vs. US recessions



Source: Bloomberg, Santander.

Chart 25: 2s10s in USTs – with and without the estimated impact of asset purchases USTs



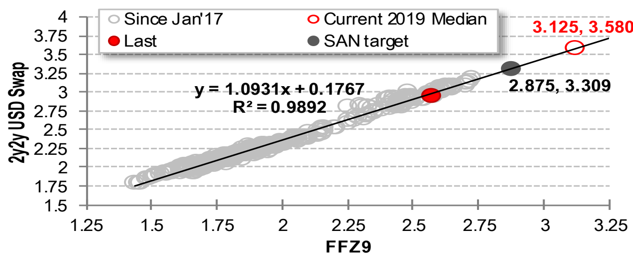
Source: Bloomberg, Santander.

…so, stick to our long-held call of paying at the front end

As a result, we think that our strategic positioning in the US curve (paying the 2y2y) has room to keep on performing, even after having run c.100bp since we first recommended entering this trade (back in September 2017).

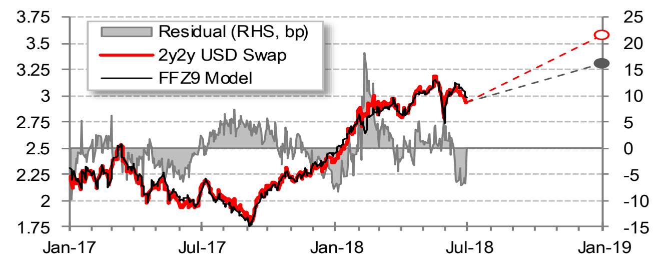
As shown in Chart 26, the correlation between the 2y2y in USD swaps and the FFZ9 future remains very high (R2=98.9% since Jan'17). With the Fed raising the median of the 2019 dots to 3.125%, the linear regression suggests that the 2y2y (currently at 2.97%) could end up trading at around 3.5% in the next few months, if the Fed finally hikes as much as suggested by the dot plot (FF @ 3.00-3.25% by Dec'19). As discussed in the previous pages of this report, we tend to think that the Fed might finally get cold feet in 2019 and end the year at 2.75-3.00%; but that would still be consistent with the 2y2y trading at around 3.30% in the next few months, hence suggesting that there is room for further gains in paying that fixed rate.

Chart 26: 2y2y USD swap rate vs. FFZ9 future – linear regression since January 2017



Source: Bloomberg, Santander.

Chart 27: 2y2y USD model based on the historical correlation vs. the FFZ9 future



Source: Bloomberg, Santander.

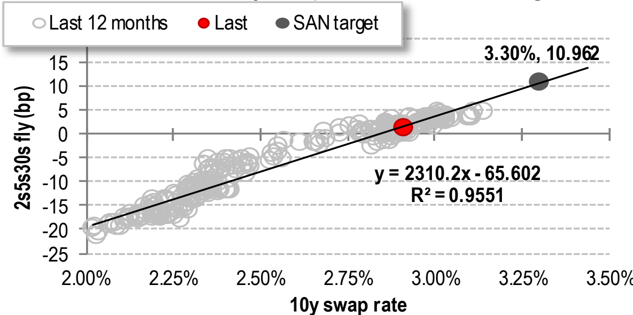
Carry-efficient alternatives to be short the belly: pay the belly in 2s5s30s

Our view on the belly of the US curve remains of higher rates in the quarters to come, although we are still unconvinced of a sizable repricing in the short run. Therefore, rather than just paying the 10y USD swap rate outright (a position that would entail a negative carry and roll-down of around 3bp in the next three months), we see value in highly-correlated trades that improve the carry and roll-down profile of the position.

In particular, we now find that the 2s5s30s fly (R2=95.5% vs. the 10y USD swap rate, see Chart 28) offers a positive carry and roll-down of around 2.5bp for the next three months. Considering the beta in the correlation, a trade in the 2s5s30s that replicates the exposure of the 10y USD rate would improve the total carry and roll-down of the position by over 13bp.

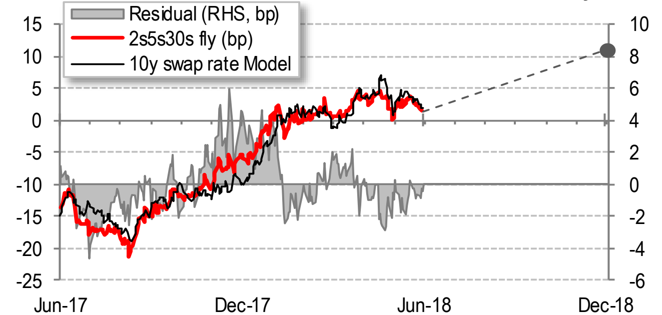
- **Trade idea: Pay the belly in 2s5s30s USD swaps**
  Entry level = 2bp. Target level = 10bp. Stop loss = -2bp
  3m carry = 0.6bp. 3m roll-down = 2.1bp

Chart 28: 2s5s30s vs. 10y swap rate – 12m linear regression



Source: Bloomberg, Santander.

Chart 29: 2s5s30s model based on correlation vs. the 10y rate



Source: Bloomberg, Santander.

Euro zone Economic Outlook

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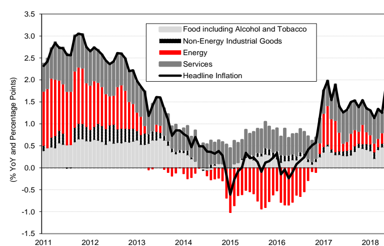
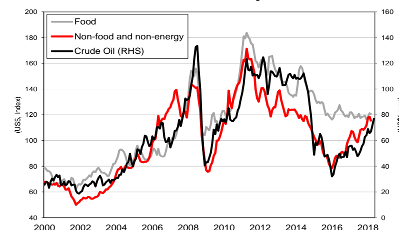
Euro zone inflation could average above 1.5% in 2018E and 2019E, with the main novelty being the rise in core inflation. The positive contribution from import prices could very likely continue, and we believe that the risks are clearly biased to the upside and mainly relate to the impact of the recovery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

Chart 30: CPI and breakdown



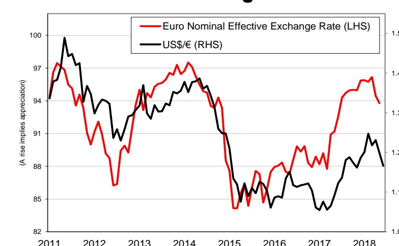
Source: Eurostat, Santander.

Chart 31: Commodities prices



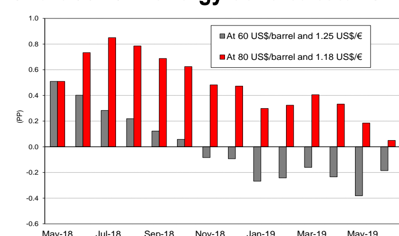
Source: ECB, Santander.

Chart 32: Euro exchange rate



Source: BoE, Bloomberg, Santander.

Chart 33: CPI energy cont. to total CPI



Source: Eurostat, Santander

Clear rise in inflation towards the ECB's target

In a context of consolidation of the recovery in activity and spending in the area, inflation not only remains in positive territory but has also risen noticeably recently towards the ECB's target. This increase has been supported by all the main components.

Euro zone headline inflation rose to 1.9% YoY in May, supported by energy at 6.1% YoY, food at 2.5% YoY and core inflation at 1.1% YoY, the latter including non-energy industrial goods at 0.3% YoY and services at 1.6% YoY.

We maintain our forecast for the Euro zone headline inflation of close to 2.0% YoY for the rest of the year and with the focus on the performance of core inflation that could rise above 1.5% YoY in 4Q18E. Note the existence of significant upward risks to inflation derived from the upturn in the labour market, the rise in oil prices and a clear willingness by companies to raise prices charged.

Increasing prices from outside…

The Euro zone has been importing inflation since the end of 2016, with trends in energy prices particularly noteworthy. That said, the marked appreciation of the nominal effective euro exchange rate (more than 9.0% between mid-2017 and the beginning of 2018) significantly moderated the impact on domestic prices and costs of the increase in commodity prices.

That said, recently, this upward movement in international prices has intensified and, at the same time, the euro has lost some traction, increasing the external upward risks for Euro zone inflation.

In the graphs on the left we show our estimates of the direct impact on total inflation of higher oil prices in euros, although we believe the main uncertainty comes from the lag in their transfer to other CPI components (core prices), particularly when the economy remains in expansion mode.

… and core inflation is also building upward dynamics

In general, we find that the CPI baskets (core CPI included) continue progressively moving towards the right-hand side of the distribution curve, that is, towards higher annual rates in comparison with their historical averages, even if there are still differences between countries in the speed of that movement.

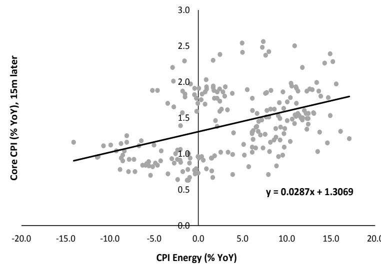
The German case stands out, as c32% of the core CPI components are posting annual rates above their historical average, something that contrasts with Italy, where nearly 30% of core inflation remains on the left side of the distribution curve.

For the Euro zone as a whole, the bulk of the distribution is centred on around its average after a period of active change. In May 2018, 17.1% of the core CPI basket remained below its average, which compares with 32.4% in September 2016. At the same time, 13.4% is currently above its average vs 6.5% in September 2016.

We maintain our view that headline inflation could be quite uneven in coming months, mainly due to 'noise' from the most volatile components and to base effects, while we expect the upward pressure from core inflation to consolidate.

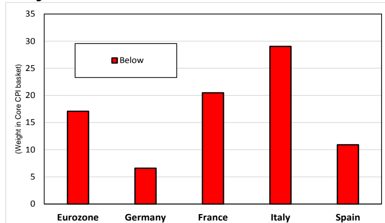
Inflation perspectives and the ECB

Chart 34: Core CPI and energy



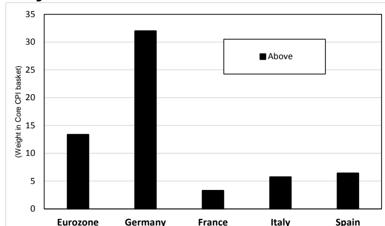
Source: Eurostat, Santander.

Chart 35: Core CPI: YoY more than one deviation below its average, May18



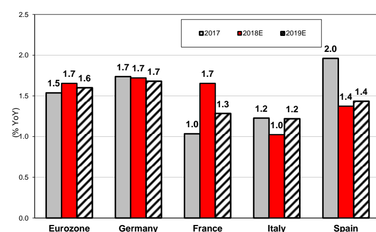
Source: Eurostat, Santander.

Chart 36: Core CPI: YoY more than one deviation above its average, May18



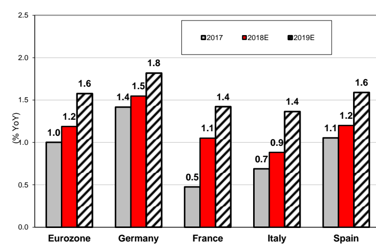
Source: Eurostat, Santander.

Chart 37: Headline inflation forecasts



Source: Eurostat, Santander.

Chart 38: Core inflation forecasts



Source: Eurostat, Santander.

In our view, overall upward pressures on companies' prices are increasing, due to a rise in the costs of production, on the one hand from the gradual reduction in the surplus in labour supply and, on the other hand, from the rise in commodity prices. The inflationary pressures coming from the labour market are still quite contained, thanks to the increase in productivity and the modest performance of salaries, which are keeping unit labour costs under control so far. But this situation may change and the shortage of employment in some activities could mean some pressure on wages. In fact, business confidence surveys show an intensification of the expected upward trend in prices charged in the coming months in construction, manufacturing and services. Note that, in the industrial sector, this movement towards higher prices is faster in domestic markets, while in the services sector the performance of transport-related activities clearly contrasts with others, such as communications, which are still deflationary.

In summary, we expect Euro zone headline inflation to average slightly above 1.5% in 2018E and 2019E, with the main novelty coming in the form of generalised higher rates of core inflation.

In our view, this performance will have to be incorporated by the ECB into its statement about the risks for inflation. In the June meeting, the ECB cut its Euro zone GDP growth forecast for 2018E to 2.1% (vs 2.4% anticipated in March) while for 2019E and 2020E, GDP forecasts remain at 1.9% and 1.7%, respectively (the ECB maintains a central projection of 0.5% QoQ for all the quarters in 2019E and 0.4% QoQ for the ones in 2020E). Risks for growth remain broadly balanced (although the ECB pointed to the more prominent threat of increased protectionism as well as financial market volatility).

We believe that these changes in the Euro zone growth forecasts have to be understood in a context of quite disappointing 1Q18 GDP figures (reducing the starting point for the rest of the year), which were affected negatively by transitory factors that are mostly over. In other words, the ECB maintained its positive stance about the Euro zone GDP performance in the coming quarters.

Against this backdrop, the ECB also revised its inflation estimates considerably to an average of 1.7% for both 2018E and 2019E, which compares with 1.4% in March, and its forecast remains at 1.7% for 2020E (unchanged vs March). According to the ECB, inflation is likely to remain around the current level for the rest of the year (it is seen at 1.9% YoY in 4Q18E) and, in our view, implicitly, the revision of the technical assumptions behind the forecasts for oil prices and the euro exchange rate in coming quarters imply that risks for imported inflation have also increased.

Underlying inflation has risen from its lows, and the ECB's recognition that domestic cost pressures are strengthening is significant (mainly on high levels of capacity utilization, tightening labour markets and rising wages), leading to expectations of an increase in core inflation at the end of the year. On average, core inflation is expected at 1.1% in 2018E to rise to 1.6% in 2019E (from 1.5% in March) and 1.9% in 2020E (from 1.8%).

The ECB's macroeconomic forecasts for June are closer to ours, although we believe that there is room for higher GDP growth. We forecast Euro zone GDP growth at 2.3% in 2018E and 2.2% in 2019E and expect this to bring an increase in the risks for core inflation. At the end of the day, we see a scenario of nominal GDP growth and a balance of risks that is consistent with a progressive removal of the current accommodative monetary policy.

Euro Rates Strategy: 'Dovish' ECB and latent risks have depressed rates but recovery seems on track

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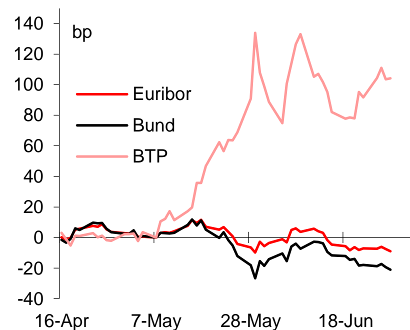
- **In addition to concerns about Italy, core EUR rates have been pushed lower by a dovish interpretation of ECB policy guidance as well as broader economic fears. Real rates look low.**
- **The market focus on Italy should gradually shift from pure politics to specific fiscal issues, where we still see risk.**
- **Strong fundamentals underpin SPGBs, which have continued to perform well.**

ECB guidance and lingering risk-off effects have kept EUR rates low

When we wrote our previous Interest & Exchange monthly in late May, the **EUR rates market was dominated by events in Italy**, with both direction and spreads reacting largely to fluctuations in BTP risk premia. The Italy factor remains a key driver in EUR fixed income but **recent price action also reflects two broader considerations**: a) the ongoing **debate about the durability of the macroeconomic expansion** at G10 level and b) **developments in the ECB's monetary policy communication**. Looking ahead to July, these three factors are likely to continue to shape EUR rates.

Chart 39: Three EUR 10y rates relative to 7 May level

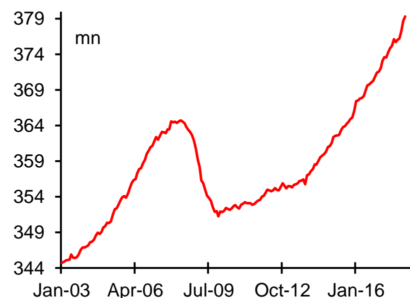


Source: Bloomberg, Santander

With regard to Italian risk-on/risk-off effects, as we explain more fully in the periphery section below, it seems likely that volatility will remain higher than normal. That said, the approaching holiday period and the focus on the budget, in autumn, suggest that the second-order **directional effect from the Italian side of things should be relatively neutral in July**. To put this into perspective, consider that in the last three weeks of May, during which time the 10y BTP yield rose by 135 bp, the 10y Bund yield fell by 25-30 bp but the more neutral 10y Euribor rate only dipped 10 bp (Chart 39).

The macroeconomic consensus has fluctuated between more or less optimistic scenarios since leading indicators took a tumble in 1Q. The economy remains a crucial question, given the divergence between the Fed's 'dot plot' of future monetary policy and the considerably less aggressive profile implied by market rates. On the economy-bullish, bond-bearish side, **1Q real GDP data was still above potential growth estimates across G4 and the leading indicators suggest that 2Q figures will be in the same vicinity**.

Chart 40: Rapid employment growth in G4



Source: Eurostat, BLS, ONS, IMF, Santander

Employment growth continues to be robust (Chart 40) and both **wage and core inflation**, though still quite moderate, have accelerated. Pessimists, however, can point to volatile equity and EM markets, in a very **debt-laden global economy** as well as **escalating tensions in international trade relations**. We doubt that this debate will be settled in coming weeks, which places more importance on the starting valuation of EUR rates.

Besides the mixed economic reality mentioned above, another restraining factor for rates is the ECB's enduringly loose stance. This was perhaps where the greatest innovation of the past month occurred, in terms of market information. Before the June Monetary Policy meeting, most analysts anticipated that the decision regarding the Asset Purchase Programme (APP) would probably be taken in July. Furthermore, indications regarding forward guidance had been minimal.

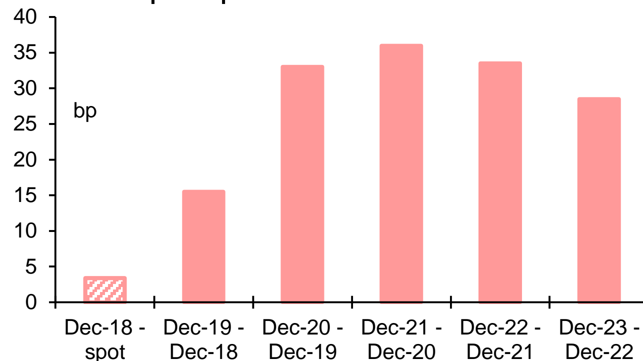
On the contrary, **the 14 June meeting signalled an important set of changes**. The **APP is expected to end in December**, after a €45bn extension (mini-taper) of the previously announced September end-date. This was *broadly expected*. Beyond that, the **ECB introduced 'enhanced**

forward guidance' concerning policy rates, which are now supposed to stay **unchanged through the summer of 2019**. In comments at the Sintra conference, Draghi underscored that time commitment and added that the ECB would "take a **gradual approach to adjusting policy thereafter**". Of course, all such statements are data-dependent and malleable but the net effect, unsurprisingly, was to drive near-term rate expectations lower.

The 3m Euribor future contract for Dec-2019, which discounted as much as a 55 bp increase **relative to the spot 3m rate, is now discounting just under 20 bp in rate rises**. Perhaps more impressively, the Dec-2020 contract is discounting just a 50 bp increase (it was 100 bp early this year). Indeed, the EUR term structure is quite flat beyond those dates, with a roughly **30-35 bp annual interest rate rise discounted out to 2023** (Chart 41). Taking on board what the ECB has been saying, the first rate hike seems likely to come in 3Q of next year, but we would expect a slightly less reticent pace of tightening after that, if the economic expansion continues. **We currently expect a 40 bp upward move in the Deposit Rate in 2019** and more after that.

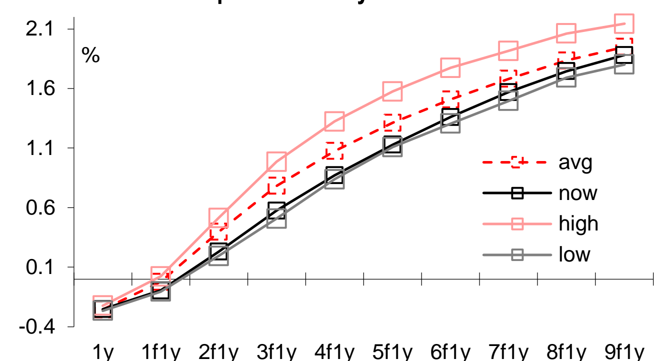
Looking further along the EUR term structure (split into 1y slices), most rates out to 10y are quite close to their 2018 lows and well below their 2018 average (Chart 42). Equally, though, we can see that rates like **the 3f1y and 4f1y are a full 20 bp below their 2018 average** while the 8f1y and 9f1y are just 5-10 bp below it.

Chart 41: Slope of spot-fwd 3m Euribor rates



Source: Bloomberg, Santander.

Chart 42: Euribor spot-forward 1y rates vs. 2018 levels



Source: Bloomberg, Santander.

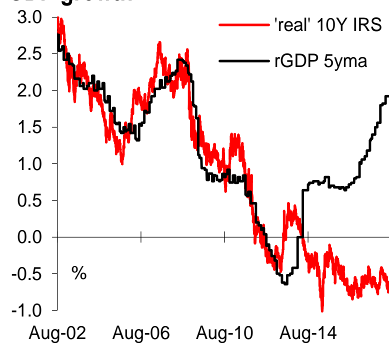
Barring much greater financial volatility or unforeseen economic developments, the **next ECB meeting, on 26 July,** is unlikely to produce any significant changes in the policy message. In that sense, **commentary by the broader set of GC members** should be as interesting as the 'official' Draghi line in coming weeks.

Market pricing assumes a dovish outcome, especially at the front end and in real rates

To sum up our directional outlook, we recognise that there are still many factors preventing rates from rising rapidly and consequently we are far from being *very* bearish. Nonetheless, after the recent correction, Bunds and other core EGBs offer very limited value. **More strategically-oriented liability managers / investors should find the current level of Euribor rates a good entry point for duration extension / reduction.**

Beyond basic duration modification, in terms of positioning we see two key threads that are worth exploring. The first, which we mentioned in last month's I&E and recently reiterated, is the **real rates / inflation breakdown**. Very simply put, market-implied inflation remains close to recent highs and well above both core y/y and long-term moving averages of inflation (though below current y/y all-items inflation).

Chart 43: 10y Real rate and 'trend' GDP growth



Source: Bloomberg, Eurostat, Santander

Conversely, **'real rates' are close to the lower end of their historical range** and far below trend growth (Chart 43). Although ultra-low real yields clearly reflect the ECB's aggressive buying via APP (especially in relation to modest Euro area supply), it also reflects expectations of monetary policy normalisation which, as we illustrated above, seem to be quite conservative.

Trade idea: Higher real rates in 10y tenor/maturity

In derivatives: pay 10y Euribor IRS and receive 10y ILS (EMU ex-tob. HICP). The real 10y Euribor rate is -0.75% and we target-0.45%.

In cash bonds: sell Bund€i 0.1% Apr-2026 at a yield of -1.29% and target -0.8%.

The second interesting way to 'overlay' a modestly bearish directional view is the **cure relationship between the 1-5y and 6-10y portions of the EUR term structure**. During the late-2017/early-2018 sell-off, as slightly more hawkish policy expectations were built into the EUR term structure, the **relative steepness and dispersion of Euribor rates in the 1-5y part** (1y to 4f1y) **of the curve had begun to drift back to historically more typical levels, compared to the 6-10y part** (5f1y to 9f1y).

Following the ECB's enhanced guidance, the 'crisis era' volatility / slope pattern has returned to the curve. At current levels, this observation *does not equate to a curve trade recommendation* but, more simply the view that **the 5y maturity is arguably the optimal area for short-duration trades in 'nominal' rates**.

Trade idea: Higher nominal rates in 5y tenor

In spot terms: pay 5y Euribor (0.26%) or sell 5y OBL (-0.31%), targeting, respectively, a 20 bp to 30 bp retracement higher.

In forward terms: pay the 2f2y rate at 0.40%, targeting 0.60% initially.

Periphery fundamentals' divergence increasingly reflected by spreads

Chart 44: BTP-Bund 10y spread is quite volatile

Source: Bloomberg, Santander

We updated our outlook on periphery EGB spreads quite recently[1] and, notwithstanding ongoing volatility, the main themes and conclusions are unchanged.

Italian politics and potential fall-out in policy terms are still centre-stage. Through much of May and even June, investor reaction to each government statement and political appointment has been largely a function of whether it suggested more or less commitment to Italy's continued membership of the EMU. Any sign of scepticism causes BTP spreads to widen and vice versa. Although any substantive development on that front would be of crucial importance, of course, we think that **reactions to purely political headlines should fade** given that:

- The Finance Minister and Prime Minister have reiterated Italy's commitment to the euro and fiscal discipline.
- A large majority of Italian voters supports continued EMU membership, notwithstanding very mixed views about the overall project and dissatisfaction with two decades of virtually no per-capita GDP growth.
- **The emphasis of policy initiatives from the new government has been on other issues**, primarily the border control / migrant question. This plays well with the electorate (based on poll ratings) and looks like

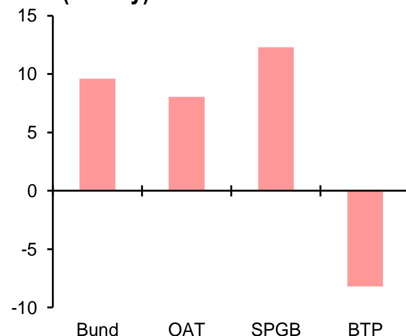
[1] See: "Periphery spreads are volatile but we expect SPGBs to outperform" – 22 June 2018.

creating leverage within the EU due to domestic pressures and divisions among the member states on that issue.

Notwithstanding the above, the fiscal promises contained in the coalition government 'contract' are presumably not going to be ignored, as they also played a crucial role in attracting votes. **Even a reduced version of the tax cuts and spending increases** mooted in that document **would imply a substantial deterioration in Italy's fiscal balance**, which is generally viewed as unaffordable, given the high debt/GDP ratio. Over the summer months, this set of questions could become more dormant (unlike the migrant issue) but the autumn budget will start being discussed in September. We remain concerned about spread volatility in Italy and believe investors should be **neutral to underweight on BTPs**.

The news flow in Spain has been relatively light, with the transition from a PP-led to a PSOE-led minority government making few waves, so far, in the market. Critically, there has been no suggestion of substantive changes in the overall fiscal or monetary stance of Spain, which is the key factor for bond investors. **The pace of job creation and real output growth in Spain remain at strong, above-average levels**. For instance, 1Q figures put GDP growth at 3.0% y/y (real) and 4.3% y/y (nominal), compared to 2.5% and 3.9% for the EMU as a whole. Budget figures look solid and, as a consequence, **the debt/GDP ratio should shrink again this year**.

Chart 45: Sharpe ratio of EGBs in 2018 (all > 1y)



Source: Bloomberg, Santander

Perhaps one of the most iconic examples of the fundamental divergence between Spain and Italy currently is the path of sovereign credit ratings. **On 13 July, Spain is due to be reviewed by Fitch (A-) and Italy by DBRS (BBB h)**. The Spanish rating was raised one notch in January and another change is unlikely. There is, however, the potential for the outlook to be changed to 'positive', although rating agencies do tend to act slowly on the way up. In Italy's case, a rating cut seems unlikely but a negative outlook is possible.

Based on future expectations and their recent track record, **we believe that SPGBs will continue to produce better outright returns and a better Sharpe ratio than a mix of Bunds and BTPs** (Chart 45). **EGB-benchmarked investors should be overweight SPGBs.** As we recently pointed out, the middle of the term structure (5y to just under 10y) is by some metrics the cheapest part of the Spanish curve, in spread terms vs. core. However, there essentially is not a 'rich' part of the SPGB curve when compared to Bunds.

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

We have two 'tracking' trades currently outstanding but this applies to the whole term structure.

In <u>inflation-linked (real) bonds</u>: buy SPGB€i 1% Nov-2030 and sell OAT€i 0.7% Jul-2030. The real yield spread is 85 bp and we target an earlier low of 60bp.

In <u>nominal bonds</u>: buy SPGB 0.35% Jul-2023 and sell OBL 0% Apr-2023. The yield spread is 73 bp and we target a spread of 30 bp

Euro government bond supply: YTD update

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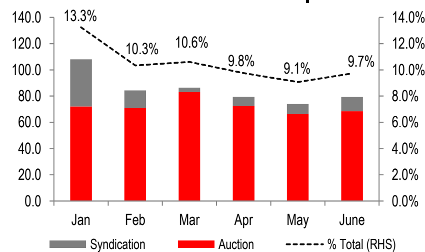
Changes in the Eurozone's combined issuance target

According to the Kingdom of Spain's latest presentation, on 5 June the Spanish Tesoro modified Spain's gross financing needs for this year (to amortise more ESM debt), but left net funding unchanged at €40bn. As a result, in medium- and long-term debt, expected redemptions have increased by €5bn to €86.3bn, taking the target for gross issuance of SPGBs and linkers to €131.3bn (vs. the €126.3bn set in Spain's funding plan at the beginning of the year).

Also, on 21 June, the German federal government modified its total gross financing needs for this year from €181bn (updated in the second quarter from the original €183bn) to €175bn. This €6bn reduction takes the target for gross issuance of capital market instruments in the third quarter down from €43bn to €37bn and for the entire year to €147bn (vs. €153bn before).

Considering the changes in Spain (from €126.3bn to €131.3bn) and Germany (from €153bn to €147bn), we now estimate a combined Eurozone 2018 issuance requirement equivalent to €816bn (€817bn at the beginning of the month).

Chart 46: YTD issuance completion

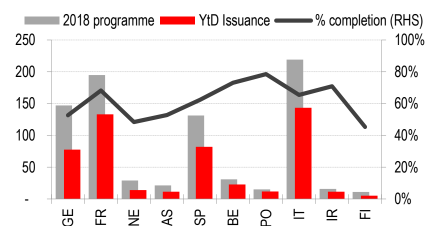


Source: Bloomberg, Santander

Eurozone bond issuance at nearly 63% of target

As we end June, Euro area issuers as a whole have surpassed the 60% mark for their total govie bond financing requirements for 2018, selling more than €510bn worth of bonds (of the c.€816bn expected, as seen above, for 2018) via both ordinary auctions (€433.2bn) and syndicated deals (€79bn). We are seeing a slight pick-up in their issuance activity this month due partially, we believe, to the fading of uncertainties in European politics (Italy & Spain), and central banks' movements in terms of monetary policy.

Chart 47: 2018 YTD issued vs. target

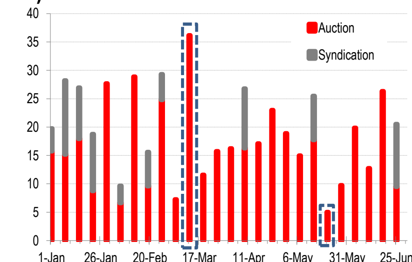


Source: Bloomberg, Santander

Issuers apparently delayed their decision to bring new bonds to the market last month, awaiting calmer waters. This is a pattern that has not been seen in previous years because issuance activity generally slows down due to the proximity of the summer months. Chart 46 shows EUR countries' issuance in the first six months of the year and we can clearly see that activity in the first three months was higher than in the second quarter, despite the ECB's EAPP. And so far, May has been the month with the least issuance activity this year.

In June, EUR govie bond supply as a percentage of the 2018 needs was the second lowest of the year, with the volume of both auctions and syndicates lower than in the first four months. June's total reached €79.4bn, or 9.7% of the Eurozone's 2018 issuance requirements, which is a tad higher than the lowest percentage of the year (9.1%) seen in May, but below the monthly average of €85.3bn (from January to June).

Chart 48: Weekly EZ supply – YTD (€ bn)



Source: Bloomberg, Santander

The weekly average issuance for the Eurozone was €19.7bn over the period to the end of June. So far this year, the second full week of March (commencing 12 March) has still seen the largest weekly volume, with €36.2bn placed, including syndications, while the week commencing 21 May shows the lowest volume, at just €5bn (see Chart 48).

In terms of the numbers shown in Table 4, as of 29 June, Italy heads the pack with around €143bn, which includes the BTP Italia retail bond sale conducted in the middle of May. France (with €133bn) is in second place and Spain in third (with c.€82bn), while Germany is next with €77.5bn. The rest of the Euro issuers have not yet surpassed the €25bn mark, with Belgium being the closest, having issued €22.7bn so far. The Netherlands (€14bn) comes next, followed by Portugal (€11.8bn), Austria (€11.4bn), Ireland (€11.3bn) and, finally, Finland (€5bn).

In terms of YTD completion rates by country, Portugal continues to lead the Euro area issuer ranking, with nearly 80% placed (at 79%) followed at some distance by Belgium (with 73%) and Ireland (71%). France is very near the 70% mark (at 68%), followed by Italy and Spain (65% and 62%, respectively). Lastly, in the 50%-plus club, we have Austria and Germany (tied at 53%), while Finland finds itself below that mark with 45% (see Table 4 for more details).

Table 4: Total issued in EZ in 2018, by country (updated as of 29 June)

	GE	FR	NE	AS	SP	BE	PO	IT	IR	FI	TOTAL EZ (€bn)
YtD auctioned issuance	77.5	125.5	14.0	7.4	58.9	13.2	4.8	126.7	3.3	2.0	433.2
YtD syndicated issuance	0.0	7.5	0.0	4.0	23.0	9.5	7.0	16.7	8.0	3.0	78.7
YtD Issuance	77.5	133.0	14.0	11.4	81.9	22.7	11.8	143.4	11.3	5.0	511.9
2018 programme	147.0	195.0	29.0	21.5	131.3	31.0	15.0	219.0	16.0	11.0	815.9
% completion (RHS)	53%	68%	48%	53%	62%	73%	79%	65%	71%	45%	62.7%

Source: Bloomberg , Santander

Table 5: YTD issuance completion vs. historical data

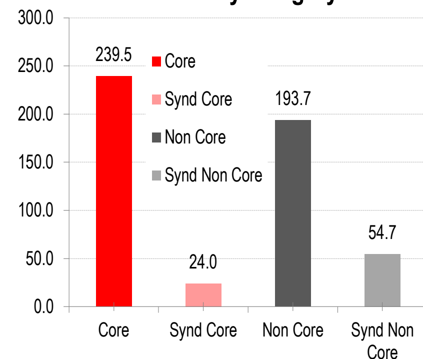
	2013	2014	2015	2016	2017	2018	Aver 13-17
GE	51%	52%	53%	53%	52%	**53%**	52%
FR	60%	59%	58%	58%	58%	**68%**	59%
NE	70%	70%	66%	59%	61%	**48%**	65%
AS	49%	53%	57%	53%	52%	**53%**	53%
SP	61%	63%	60%	57%	62%	**62%**	60%
BE	66%	68%	62%	62%	70%	**73%**	66%
PO	100%	47%	63%	71%	67%	**79%**	70%
IT	56%	61%	61%	56%	61%	**65%**	59%
IR	100%	55%	85%	67%	57%	**71%**	73%
FI	48%	46%	57%	63%	58%	**45%**	54%
TOTAL EZ (€)	**58%**	**59%**	**59%**	**57%**	**59%**	**63%**	**59%**

Source: Bloomberg. YTD (calendar year) data for 2018. Jan-Jun aggregates for historical data.

As shown in Table 5, a number of EUR issuers have succeeded in frontloading their bond issuance this year, taking the average completion rate for the region as a whole (currently at 62%) to levels not seen at this stage in previous years (even surpassing previous record years, e.g. 59% in 2014, 2015 and 2017). According to our analysis, Belgium (73%), France (68%), and Italy (65%) have set new highs for the last five years in terms of bond issuance completion at this point of the year, while the Netherlands (48%) and Finland (45%) are at the other end of the spectrum, having issued at the slowest pace in the last five years.

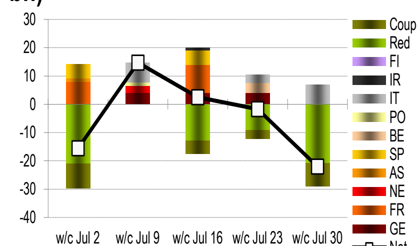
When comparing 2018 to last year's completion rates, this month Ireland is out ahead, exceeding its 2017 average by 14pp, and issuing faster than in the last three years. Portugal, France, Italy and Belgium are next, at 11pp, 10pp, 4pp, and 3pp ahead, respectively. Then, we have Germany, Austria and Spain, currently advancing at or around the same pace as in 2017, while the Netherlands and Finland are both 12pp behind.

Chart 49: Issuance by category – YTD



Source: Bloomberg

Chart 50: Expected EGB net supply (€ bn)



Source: Bloomberg

Core countries remain ahead of periphery issuers

At this point of the year, total core supply surpasses non-core supply, albeit with slight less activity in the periphery. Core issuance accounts for 51.5% of the total, or the equivalent of €263.5bn, while periphery supply makes up the remaining 48.5%, or €248.4bn. The core countries have auctioned 1.24x more than the periphery (€239.5bn vs. €193.7bn) so far in 2018, while the latter have placed 2.28x more via syndicated deals than their core counterparts (€54.7bn vs. €24bn).

Supply dynamics also to favour EUR govies at end-July

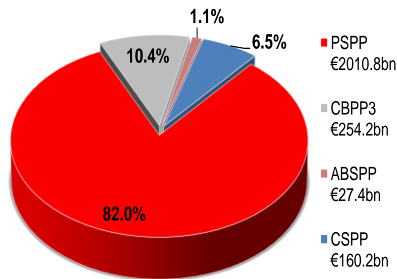
As shown in Chart 50, July has some of the highest monthly reinvestment flows of the year, as more than €88bn will return to the markets in cash. So, the July supply dynamics should play in favour of the upcoming auctions and, consequently, encourage EUR issuers to step up their pace of issuance ahead of the traditional summer break in August, and we are not counting ECB purchases. The €64bn maturing (in Germany, the Netherlands, France and Spain) and €24.5bn returning to the market in coupon payments will more than offset the €66-67bn expected to be auctioned during July. As a result, net EUR supply will be negative by around €22bn.

We would keep an eye on the big redemptions and coupon payments from **Germany** (€21bn in redemptions + €8bn in coupon payments on 4 July), **France** (€9.2bn in redemptions and €3bn in coupon payments on 25 July), and **Spain** (€20.8bn in redemptions + €8.2bn in interest returning to the markets on 30 July) during the month, as more than €85bn could be

reinvested. In addition, large cash inflows are still pending, as more than €16bn from the Netherlands is also expected to return to the market next month.

Update on the ECB's EAPP

Chart 51: The ECB's EAPP portfolio



Source: Bloomberg, ECB, Santander

On 25 June, the ECB published an update of its Extended Asset Purchase Programme (EAPP) holdings, which includes the purchases settled as of 22 June. According to the overall figures, the EAPP totals €2.45trn of assets bought since the programme began in 2015, about €47bn short of the €2.5trn mark, which could be reached within two months if the ECB maintains the current €6.7bn-a-week average pace since January. The PSPP now accounts for 82% of the ECB's monetary policy portfolio, while the CBPP3, CSPP and ABSPP represent 10.4%, 6.5% and 1.1%, respectively

By country, the latest information available is a breakdown of the PSPP debt security holdings published by the ECB at the end of May (Table 6), which we commented on in detail in our MMD report published on 5 June. In summary, May sovereign bond purchases totalled €24.2bn, slightly above the amount reported for April (€23.6bn) and bringing the total PSPP holdings to €2,042.6bn at the end of May.

Table 6: The ECB's PSPP purchases - Country breakdown

Holdings (€mn)	1Q18	Apr'18	May'18	Monthly Change	Monthly Avge	2015 Purchases	2016 Purchases	2017 Purchases	2018 Purchases	Total Purchases
Austria	1,685	631	576	-55	1,406	12,639	20,559	18,761	2,892	54,852
Belgium	2,184	801	723	-78	1,774	15,895	25,939	23,630	3,708	69,172
Cyprus	-	-	-	-	5	285	- 37	- 35	-	214
Germany	14,666	4,718	6,893	2,175	12,451	115,618	188,321	155,372	26,277	485,594
Estonia	-	-	-	-	2	48	18	-	-	65
Spain	8,237	3,103	2,829	-274	6,267	56,813	93,514	79,930	14,169	244,429
Finland	856	542	486	-56	796	8,086	13,212	7,872	1,884	31,049
France	12,192	4,565	4,161	-404	10,171	91,762	149,100	134,901	20,918	396,687
Ireland	1,248	567	518	-49	708	7,581	10,982	6,719	2,333	27,614
Italy	10,481	3,971	3,609	-362	8,841	79,204	130,398	117,120	18,061	344,788
Lithuania	- 126	42	- 25	-67	72	1,107	1,157	640	- 109	2,795
Luxembourg	79	40	11	-29	64	1,115	628	642	130	2,514
Latvia	42	29	39	10	48	685	628	430	110	1,853
Malta	43	4	17	13	28	282	525	220	64	1,091
Netherl.	3,241	1,290	1,174	-116	2,782	25,612	42,212	34,959	5,705	108,489
Portugal	1,412	623	568	-55	863	11,219	13,390	6,453	2,603	33,667
Slovenia	332	127	113	-14	192	2,229	2,705	1,974	572	7,480
Slovakia	465	170	133	-37	296	4,622	3,534	2,627	768	11,551
Sub Govies	**57,039**	**21,224**	**21,826**	**602**	**46,767**	**434,802**	**696,794**	**592,213**	**100,089**	**1,823,905**
Supras	6,441	2,407	2,404	- 3	5,607	60,101	81,126	66,193	11,252	218,674
TOTAL PSPP	**63,480**	**23,631**	**24,230**	**599**	**52,374**	**494,903**	**777,920**	**658,406**	**111,341**	**2,042,579**

Source: ECB, Santander

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- **We believe that the communications provided at the June MPC meeting left more questions than answers with regard to the near-term policy outlook**
- **We are concerned that the recent weaker CPI and wage data releases appear to be playing only a minor role in the analysis of the Committee's more hawkish members**
- **We expect this hawkish sentiment to fade in the coming weeks, as weak activity and inflation data combine with continued Brexit uncertainty.**

We see the June MPC as a missed opportunity…

In the run-up to the June Bank of England Monetary Policy Committee (MPC) meeting, we argued that the combined scheduling of an MPC announcement and Mansion House speech presented the opportunity to offer a more rigorous appraisal of the latest growth and CPI and wage data, as well as an indication of how the current uncertainty around the Article 50 negotiations may influence the monetary policy decision. In the event, the Committee offered only a brief overview of the latest UK data releases, with Chief Economist Andy Haldane's preference for an immediate rate hike providing the hawkish surprise.

Whilst acknowledging the relatively early stage of the 2Q18 data release cycle, and the political sensitivities relating to all things Brexit, we still see this as a missed opportunity for the Committee to provide additional clarity on the monetary policy outlook ahead of a critical period for the UK political and economic environment.

The Committee has, of course, already vowed to avoid a repeat of the very direct, unequivocal policy guidance which featured at the September 2017 MPC meeting, with the intention being instead to allow the strength or weakness of the data releases – rather than central bank communications – to guide market expectations of policy. But, following the June MPC meeting, we are concerned that the evolution of recent data releases – in particular the recent weakness of the average earnings and services CPI figures – appears to be playing only a minor role in the analysis of the Committee's most hawkish members. Should these data now be taking a 'backseat' in the policy decision, then the flow of data releases would as a consequence become a less powerful influence on market expectations, with the focus instead falling on policymaker communications.

…leaving more questions than answers on the near-term policy outlook

We believe that the communications provided by the MPC in June left more questions than answers with regard to the near-term policy outlook. In particular, we would focus on three areas of the latest set of MPC minutes, relating to (i) the comments made on the services CPI data; (ii) the apparent focus on survey measures of wage growth rather than the actual average earnings data; and (iii) the suggestion that a majority of the MPC may now be concerned by the outlook for growth in 2H18 and beyond, rather than the exact strength of the second quarter GDP figure. The sections below provide an analysis of each of these elements of the June MPC minutes.

1) Which elements of the CPI do the hawks regard as relevant to the policy decision?

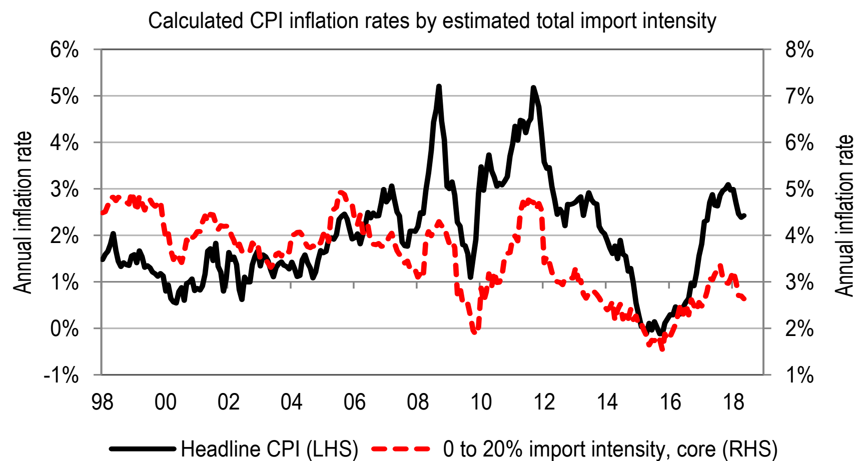
The minutes to this month's meeting show the more hawkish members of the Committee to be keen to downplay the relevance of the services CPI

data as a guide to domestically-generated inflation, despite accounting for 48% of the weight of the index. According to the Committee's hawks, the still high estimated import intensity of the service CPI series – which the MPC minutes state to be a weighted average of 17% versus the c.25% weighted average for the CPI overall - questioned its use as a guide to domestic price pressures. Similarly, we note that in the minutes to the May 2018 Committee meeting, those favouring an immediate hike attributed the weaker trend in CPI inflation overall to a reduced pace of exchange rate pass-through, and was therefore not seen to be of material importance to the medium-term inflation outlook.

Given these statements, we question which areas of the CPI the Committee's hawks do in fact regard as being most relevant to the policy decision, and why (for completeness) an appraisal of trends within the most domestically-focussed areas of the CPI was not provided in the latest set of MPC minutes. However, before outlining such an analysis below, we first question the figures provided by the MPC with regard to the weighted average total import intensity of the services CPI series.

Using the latest estimates of the import intensity of the various components of the CPI published by the Office for National Statistics (ONS) on 13 February 2018, we in fact calculate the weighted total import intensity of the services CPI to be 11.4% versus a 23.7% figure for the CPI overall, and a 35.2% weighted average for the CPI goods series. According to our analysis, therefore, the import intensity of the services CPI series is less than half that for the CPI as a whole, and we argue that this low sensitivity to import prices helps to explain the relative stability of the services CPI inflation rate in the aftermath of the 2016 sterling depreciation.

Chart 52: Inflation across the most domestically-focussed areas of the CPI remains subdued



Source: ONS, Thomson Reuters Datastream, Santander.
Note: The calculated core 0 to 20% total import intensity series accounts for 30.4% of the CPI and has a weighted average total import intensity of 11.4%..

For completeness, we have also calculated a separate inflation index containing each element of the CPI with an estimated total import intensity of 20% or less, but excluding those components relating to energy, housing rentals, transport services and education costs, in order to create a genuine 'core' measure of domestically-focussed CPI inflation. Our calculated series accounts for 30.4% of the weight of the CPI, and has an estimated weighted total import intensity of 11.4%. This domestically-focussed measure recorded an annual inflation rate of 2.6% in May 2018, having decelerated from the 3.2% pace seen in January.

Moreover, as illustrated in Chart 52, price growth in the region of 3% on this calculated measure of domestically-focussed inflation has typically been

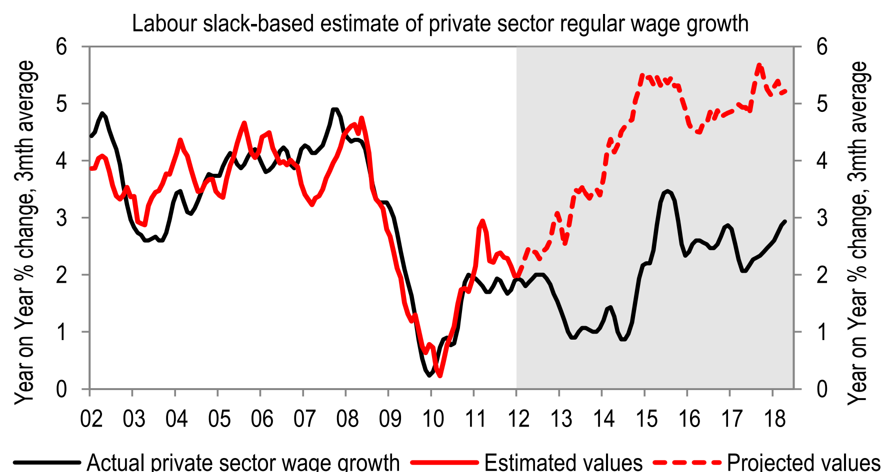
associated with a headline rate of CPI inflation close to or below the 1% level (i.e. 'Letter-writing' territory). Indeed, having fallen to a record low of 1.5% in October 2015 - when headline CPI inflation briefly turned negative - the recovery of domestically-focussed inflation observed through to the final quarter of 2017 appears to be historically small in relation to both the duration of the recovery and the overall acceleration of inflation observed.

2) Are the hawks more focussed on survey measures of wage growth, rather than the actual wage data?

As we highlighted in our recent research publication, 'New Guidance Required' (published 20 June 2018), private sector regular pay has risen at a 1.6% annualised pace in the first four months of 2018, versus 2.8% over the same period of 2017 (a level of wage growth the Bank of England's Chief Economist described in February as being 'very weak'). But this slowdown in the higher frequency measures of wage growth was afforded little prominence in the minutes to the June MPC meeting, with the reported 0.5% rise in pay settlements versus 2017 and the further increase in surveyed measures of wage growth – corroborated by intelligence from the Bank of England's Agents – being highlighted instead. Separately in the June MPC minutes, 'most indicators' of pay growth were reported to have risen over the past year, even though the average earnings data have shown a clear deceleration in wage inflation since the beginning of 2018.

In view of the apparent prominence given to the different survey measures of pay growth, we again question whether the Committee's hawkish members are now more concentrated on a range of alternative indicators of future wage inflation, rather than the evolution of the official wage data itself. Of course, some bias towards the forward-looking indicators is to be expected within the Committee's reaction function, given the intention to hit an inflation target 2/3 years ahead. The assumption of only a very small current degree of remaining slack across the economy (c.0.25%-pt of potential GDP), and the expectation of a move to a positive output gap over the forecast horizon, will also work to increase the focus upon future rather than current levels of wage growth. However, we still argue that focussing too intently on the survey data risks failing to acknowledge the inability of wage growth to accelerate towards the levels typically implied by the various labour market indicators, and indeed the persistent forecasting errors within the Committee's own wage growth projections.

Chart 53: Wage inflation has remained well below the levels implied by changes in labour slack



Source: ONS, Bank of England, Thomson Reuters Datastream, Santander.

For example, Chart 53 illustrates the results of a regression in which the annual growth in private sector ex-bonus average earnings is explained by changes in labour market slack, specifically (estimates of) the five

measures of slack outlined by the Bank of England in the August 2013 document 'Monetary policy trade-offs and forward guidance'. For the period between June 2001 and December 2011, changes within these labour slack indicators explained roughly 80% of the movement in private sector wage growth. But from January 2012 onwards, applying the observed changes in labour slack to the same econometric model generated estimates of wage growth which greatly exceeded the actual, reported level of wage inflation (shaded area of Chart 53).

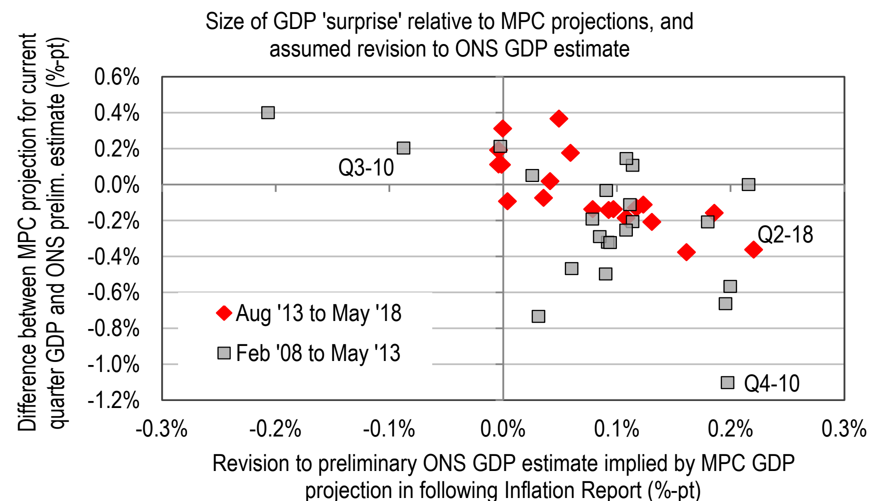
All told, we believe that the analysis shown in Chart 53 provides an illustration of the need to frequently 'benchmark' the trend in survey measures of wage growth to the actual average earnings data, in order to avoid any persistent bias developing within forecasts of domestically-generated inflation. Ultimately, we argue that a more hawkish monetary policy stance – motivated by 'alternative' measures of wage pressures – will eventually have to be justified by an actual pick-up in the official wage and CPI series, and so far we believe that the evidence of an imminent acceleration is still largely absent.

For instance, relative to the forecasts outlined in the May 2017 Inflation Report, the headline unemployment rate is currently 0.5%-pt below expectations and the oil price is roughly 35% above the level implied by the oil future curves used to condition the MPC's forecasts (in May 2017). Yet, CPI inflation is still on course to fall below the Committee's projections in 2Q18, and the Committee has already moved to reduce its 4Q18 average earnings growth forecast to 2.75% versus the 3.5% figure expected in May 2017. Overall, we argue that the growth-inflation trade-off of the UK economy, rather than the headline rate of GDP growth itself, should be the focus of policymaker attention.

3) For the majority of the Committee, is the growth outlook beyond 2Q18 now the greater concern?

Surprisingly, in our view, the June MPC minutes showed the Bank of England staff to have maintained their forecast for a 0.4% gain in 2Q18 GDP. In the near term, investor attention will fall squarely upon the release of the April index of services data on 29 June. Given the strength of the retail sales data for the month, we believe that a 0.3% gain in services output is likely in April, with the risks potentially skewed to the upside.

Chart 54: The MPC expects a large upward revision to 1Q18 GDP growth



Source: Bank of England, ONS, Santander.

Note: The chart shows the difference between the MPC estimate for GDP growth in the first quarter of each Inflation Report forecast period, and the preliminary ONS estimate of GDP growth in that quarter. The chart also shows the size of the revision to the preliminary ONS GDP growth estimate implied by the following Inflation Report's forecasts.

However, given the poor April data seen for both industrial production and construction, we believe that a very strong performance will be required by the services sector through the second quarter as a whole in order to achieve the targeted (0.45%) level of GDP growth. Moreover, while the focus will naturally remain on the incoming data releases, we also note that the MPC has assumed that an extremely positive revision (0.22%-pts) will be made to the reported 1Q18 GDP figure. As illustrated in Chart 54, this 0.22%-pts figure is in fact the largest revision (relative to the preliminary ONS growth estimate) to be signalled by the MPC for over a decade, and exceeds the revision that the February 2011 Inflation Report assumed would be made to the 4Q10 GDP figure, even though the downside surprise related to the MPC's earlier growth forecast for 4Q10 was in fact much larger (1.1%-pts). As such, we believe that the MPC is maintaining very optimistic forecasts with regard to GDP growth in both the first and second quarters of 2018, and we expect the data to ultimately force a shift in policymaker expectations.

Interestingly, however, we believe that the June MPC minutes hinted at a change in the assessment of global growth across the Committee, and by extension the level of support net exports can be expected to offer to the UK economy through 2018 and beyond. In the May 2018 Inflation Report projections, net trade is expected to add 0.25%-pts to GDP growth in 2018, 2019 and 2020, with a key judgement being that UK growth would continue to rotate towards net trade and investment and away from consumption. Importantly, this assumed net trade growth contribution could in theory prove the difference between a small degree of slack being seen to remain across the economy through the MPC's forecast horizon, or a small overheating occurring instead. We believe that the June 2018 minutes suggest that a reappraisal of these assumptions may now be underway. While the majority of the Committee is now described as being more confident of the temporary nature of the 1Q lull, the minutes in our view suggest that they are not convinced that the May 2018 Inflation Report forecast still holds in its entirety, particularly in light of the weaker global outlook. Moreover, while the Committee may remain reluctant to draw a direct link between the state of the Article 50 negotiations and the monetary policy outlook, a reduced level of expectations around the net trade contribution to UK growth may provide an easier route to express such concerns within the policy decision itself.

UK Rates Strategy: QE reinvestments moot in several respects

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- **We explore the potential causes and consequences of another surprise from the MPC minutes: a cut in the level of Bank Rate above which reducing QE assets could be considered.**
- **We believe the content and timing of this announcement make it a moot point, as the market does not believe rates will ever get that high and it has avoided getting entangled with any potential hike.**
- **Regardless, the APF will be reinvesting £3bn in July, an unusually small holding that we expect will favour (recently underperforming) ultra-short gilts relative to longer tenors which the APF buys**

Trade idea: Buy the 3T Sep'19s gilt versus the 0H 22s on ASW

Enter at a box spread of -4bp, targeting +4bp with a stop beyond -6bp. Regardless of levels, we would plan to exit the position on 23 July.

Buying the 19s (or 20s) on ASW, outright, also appeals to us.

June MPC minutes also had answers and questions on QE

The latest minutes from this month's MPC meeting included an unexpected postscript containing updated guidance on the future of the Bank's QE holdings in the Asset Purchase Facility (APF) and the Sterling Monetary Framework (SMF). The key point is that:

"*…the MPC now intends not to reduce the stock of purchased assets until Bank Rate reaches around 1.5%, compared to the previous guidance of around 2%.*"

We believe this raised even more questions, on top of those concerning the MPC's reaction function and attitudes towards data which we discuss above in the UK Economics section. In this section, we will focus on the possible meaning of the asset purchase news:

1) Why was the change made?
2) Does this matter for the market?
3) Why announce it now?
4) How might a reduction in assets be implemented?

1) Why was the change made?

We read the MPC as keen to downplay the significance of this statement, painting it as a belated, mechanical tweak. The Bank's previous guidance was set out in a box in the November 2015 Inflation Report (p34). At that point, the MPC judged the effective lower bound for Bank Rate to be 0.5%, but subsequent developments have moved that estimate "*close to, but a little above, zero*". The Bank still considers 1.5% a desirable (minimum) amount of headroom for a rate-cutting cycle, but as the reference point has fallen by almost 50bp lower, it has now dropped the threshold level into line.

It could also be speculated that, to some degree, the MPC was 'marking to market': no point on the GBP OIS forward curve has exceeded 2.00% since the Brexit referendum, suggesting that such a level is well above what the market considers a neutral (or even plausible) level of Bank Rate in the new macro/political context.

A final potential motivation is fear of missing out, with the Fed already running down its own stock of SOMA assets and even the ECB now having taken its own first steps towards the end of QE. For the Bank to be seen as standing any chance of joining other central banks' moves towards balance

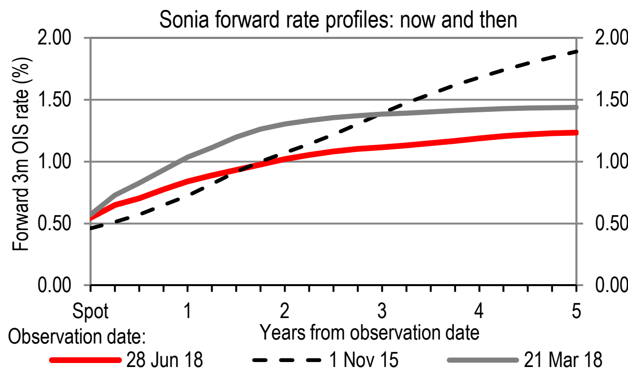
sheet reduction, the indicative exit conditions had to be relaxed. We doubt that market levels or other CB decisions were a primary motivation behind the change, but keeping aligned with them in the new 'lower forever' UK rate environment may have been at the back of their minds.

2) Does this matter for the market?

In short, we do not believe it should: despite moving the threshold, it remains well beyond market estimations of terminal rates. 5y1y forward OIS has exceeded 1.50% for only one week (this February) since the EU referendum and, as noted above, the entire forward rates curve has stayed subdued.

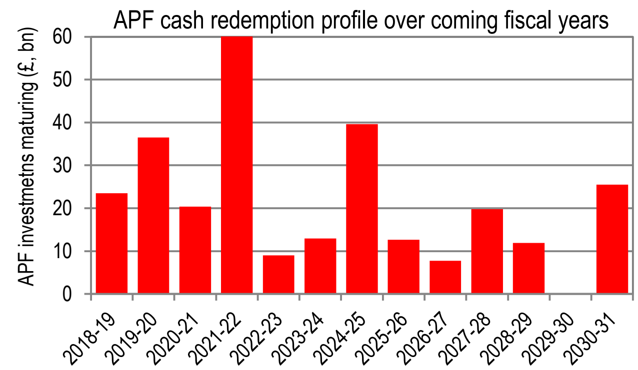
Despite the MPC's recent hawkish rhetoric, the market is pricing a very low and slow hiking cycle (Chart 55). As one of the MPC hawks' key arguments is that hiking sooner reduces the risk of needing to hike more aggressively in the future, their apparent enthusiasm to hike logically implies such a flat trajectory. And, even if 1.50% was to be reached much faster than the market (or even the MPC) seem to expect, we believe that the Bank would be unlikely to rush to take action on the APF while still adjusting Bank Rate.

Chart 55: The market-implied GBP 'terminal rate', now barely 1.3%, has declined even further than the MPC's QE reduction threshold since 2015, keeping that trigger level out of sight



Source: Bloomberg, Santander.

Chart 56: The APF's gilt holdings are extremely lumpy across (and within) fiscal years, so redemptions alone would not support a smooth balance sheet run-down process



Source: BoE, Santander.

3) Why announce it now?

We have not received many enquiries from clients recently about the future of QE and the UK's monetary policy framework – in contrast to last September, when a Bank Rate hike back to 0.50% had become priced in and questions prompted us to explore this subject in detail (see *Reserves averaging and Libor in the UK*). The Bank announced the new, lower "lower bound" in the August 2016 Inflation Report, alongside the cut to 0.25% and warning that a further cut could follow, so has had plenty of opportunity to shift the QE threshold accordingly. As with the lower bound and original QE-rundown guidance, an Inflation Report feels like a more natural place for a message like this.

We believe the answer is tied into the previous questions: the change was revealed now because current pricing means it does not have a direct market impact *and* the MPC wants to downplay it. The Committee kept August firmly 'live' for a rate hike, and likely wanted to get this QE message out of the way first: saving it for an Inflation Report meeting at which a hike occurred would have risked amplifying or confusing the message.

Another reason, which particularly cynical commentators could suggest, would be that it gave the governor something concrete to discuss in his Mansion House speech on the evening of the announcement. Again, that is likely to have been at best a fortunate side-effect rather than the explanation.

4) How might a reduction in assets be implemented?

Even though the prospect of an actual reduction in the QE stock remains a distant prospect, the occasion warrants some consideration of how it might work. Unfortunately, the (so far) very market-friendly example set by the Federal Reserve is of little help to the BoE: the almost continuous profile of UST redemptions is a far cry from the infrequent gilt events. We believe a more proactive approach would be necessary, potentially with more of a steepening impact on the gilt curve than passive roll-offs (depending on execution details).

There is a pertinent paragraph in the minutes:

"Any reductions in the stock of purchased assets would be conducted over a number of years at a gradual and predictable pace. The MPC continued to view sales and reinvestment decisions as equivalent from a monetary policy perspective."

The annual profile of gilt redemptions may be "predictable", but is far from "gradual" in our eyes (Chart 56). The MPC has consistently noted that sales and redemptions are interchangeable, which seems to be preparing the ground for some contribution to a more active plan.

As a specific thought experiment to make this point, let us suppose the MPC favoured a full reversal of the August 2016 easing package before further Bank Rate hikes, and therefore announced a £60bn reduction in the target stock of QE at the August 2018 meeting. The redemption on 22 July would already be over, and the next gilt redemption, of £20.6bn, is not until 7 March 2019: seven months and four MPC meetings away. Conditions could change and the decision be reversed before any change in the APF's holdings! The APF would then, at last, shrink by £39bn over the next six months, but followed by another six-month hiatus. The full £60bn adjustment would only be completed in July 2020, almost two years after the decision.

Some form of auction process, similar to how the APF acquires gilts, would seem an obvious starting point. This would have the double-edged feature of giving the Bank some influence on how the yield curve is impacted (cf. "Operation Twist" in the US), although that might be seen more as a curse than a blessing by drawing the Bank deeper into market functioning. If the mechanism mirrored the existing purchase operations closely, spread across the curve in three equal buckets, we would expect the process to weigh on the 3-4y and 15-25y regions that normally see little or no DMO supply.

An alternative is hinted at by the Bank's APF communications' frequent emphasis on consultation with the DMO. Selling uniform or pro-rated packages of gilts to the DMO on a regular basis, say at their FTSE-Tradeweb EOD reference prices, would be one mechanism by which the APF could shrink its holdings without a direct market impact. That interaction would then be managed by the DMO as part of its overall (increased) gilt financing strategy, without a second agency needing to develop its own policy and expertise while attempting to remain in sync. The DMO already holds an extensive portfolio of gilts (nominal value of £102bn at the end of March), used for repo operations, so the concept is not a new one. If this approach was to be adopted, the main OTR tenors (5y, 10y and 30y) would likely suffer most from the increased pace of supply, although the DMO could tap off-the-run bonds more often to smooth out any clear distortions that arose.

The July redemption will be an unusually small APF event

Regardless of this change to QE's distant prospects, the Bank also confirmed that the 1Q July 18s' redemption will be reinvested in the normal

manner, in the week commencing 23 July.

That gilt maturing has an unremarkable total size of £35bn, but an unusually low proportion of it is held by the APF. As a result, the QE reinvestment will be the smallest for almost five years, and the market will then have to wait until March 2019 for a more material reinvestment operation (Table 7).

Every round of purchases is unique in some ways, but the private investor/APF balance makes this one particularly unusual. We find the closest historical comparison to be the 2Q Jan'15s.

Table 7: Details of previous and upcoming APF reinvestment periods

From	To	Bond size	Market holding	APF cash	APF share
11-Mar-13	25-Mar-13	34.3	23.1	6.6	21%
30-Sep-13	03-Oct-13	8.7	4.2	1.9	27%
10-Mar-14	24-Mar-14	35.1	25.1	8.1	25%
08-Sep-14	08-Oct-14	40.6	21.7	14.4	37%
26-Jan-15	**28-Jan-15**	**28.8**	**23.7**	**4.3**	**15%**
06-Sep-15	30-Sep-15	38.4	16.5	16.9	48%
07-Dec-15	16-Dec-15	10.5	2.5	6.3	66%
25-Jan-16	03-Feb-16	32.5	22.9	8.4	26%
06-Feb-17	13-Mar-17	29.1	19.8	11.6	40%
04-Sep-17*	20-Sep-17	43.2	22.1	10.1	19%
12-Mar-18	17-Apr-18	35.2	13.1	18.3	55%
23-Jul-18	**25-Jul-18**	**34.8**	**30.6**	**2.9**	**9%**
11-Mar-19	10-Apr-19	36.4	15.5	20.6	54%

Source: DMO, BoE, Bloomberg, Santander. Amounts in £ bn.
Note: The Sep'16 redemption is not included, as its reinvestment was rolled into a £60bn APF extension. * The Sep'17 reinvestment operation was of two redemptions together, which we have aggregated here.

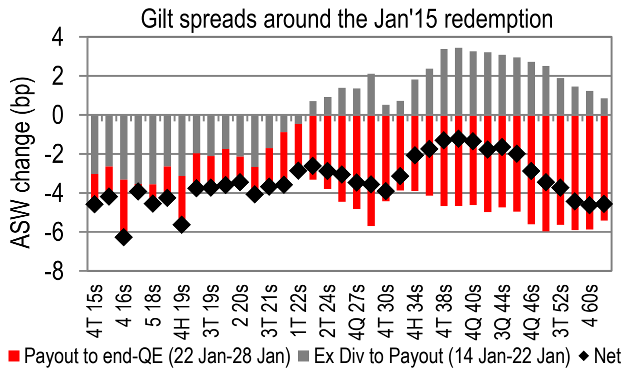
In theory, we would expect such investor-oriented holdings to support the short end of the gilt curve much more than usual. Hold-to-maturity investors should naturally have a bias towards reinvesting at short dates – note that many gilt indices have a 1y minimum maturity rule, so passive trackers who would tend to buy evenly across the curve should have sold well before redemption. In contrast, the APF does not buy below 3y at all, its current holdings necessitate concentrated purchases of the recent 10y benchmarks (25s-28s) and one third of the cash goes into the long end.

This pattern is borne out, with nuances, by the evolution of gilt spreads around the Jan'15 redemption (Chart 57). The ex div period, when investors are clear to start putting their imminent cash to work, saw particular strength towards the front end. Longer tenors did better the following week when the APF was buying; while the short end extended its gains, albeit by less.

The upcoming redemption is even more market-skewed than that example, which we see as implying an even stronger spread-steepening influence during the ex div period. Looking at recent gilt performances highlights the very front end as having a particularly weak run, perhaps overshadowed by recent firmly hawkish expectations for coming MPC meetings (Chart 58), and offering a tempting entry point for buying on ASW.

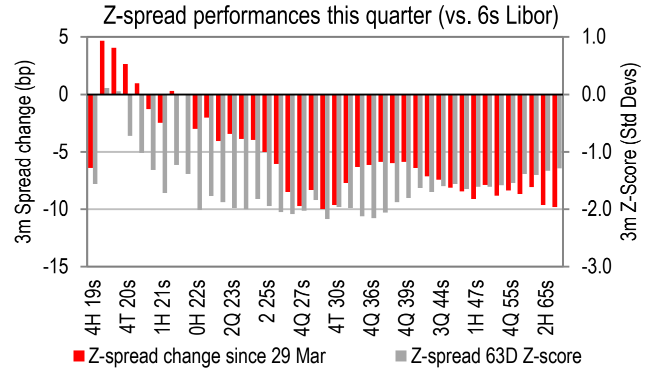
Once the redemption itself is out of the way, the limited APF buying may provide the gilt curve with a little flattening nudge, as in January 2015. An even stronger flattening force could then come from month-end rebalancing: the 1T Jul'19s and 0T Jul'23s drop maturity buckets at the same time as the redemption, increasing relevant gilt index durations by ~0.3y and prompting passive funds to extend. Come 20 July, we would be planning to close this position, and considering ASW flatteners or wideners in longer tenors.

Chart 57: The gilt spread curve pivoted steeper during the Jan'15s ex div period, although parts of the long end caught up over the following week (during the APF purchases)



Source: Bloomberg, DMO, BoE, Santander.

Chart 58: Short gilts have seen little benefit from this quarter's risk-off spread widening, on outright change or Z-score metrics, adding to the 19s and 20s' appeal ahead of the redemption



Source: Bloomberg, Santander.

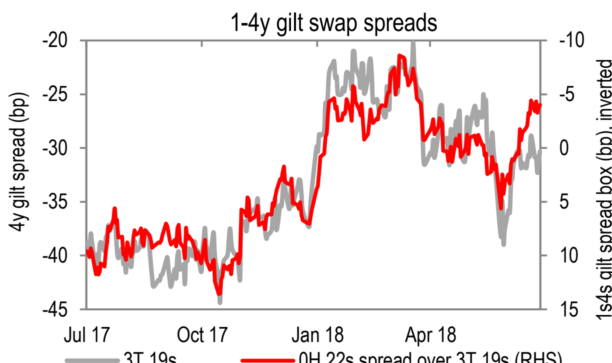
The 1T Jul'19s and 3T Sep'19s, in particular, have tightened despite the 4H Mar'19s managing to join the widening. The 4H 19s' spread is wider than those longer maturity bonds (whether versus Sonia or Libor), so 'roll-up' should not be a factor despite 4y being the outright widest point on the spread curve.

Indeed, that trough in the spread curve leads us to consider a 1s4s spread steepener (or, from another perspective, switching to the 19s from longer bonds) as an alternative to outright buying. The box is closely tied to the 19s spread, and even flatter than would normally be implied by its level (Chart 59).

Short gilt spreads are often quite co-directional with monetary policy, so further hawkish signals from the BoE present a risk to this idea. We would plan to exit this trade after the redemption, unless deliberately choosing to make a dovish BoE play at the time, so would have already closed the position even if we are proved wrong and the MPC does hike in August. With a 60% chance of an August hike already priced in, we see little reason for Committee members to intervene to push those odds higher in the meantime.

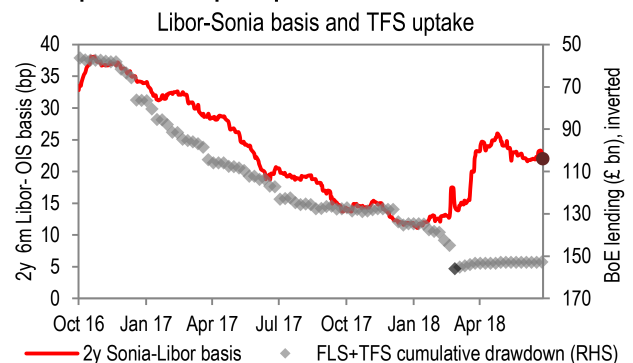
Another threat to long gilt ASW trades, in general, is an unexpected decline in political risk (pricing), reversing the 'safe haven' flows into gilts since late May. But, as short gilts have failed to widen in that move so far, they should also largely shrug off a reversal. The spread steepening structure could even benefit from fear fatigue, although we expect recent conditions to continue, if not intensify (as explored in our Gilt RV Focus of 22 June).

Chart 59: Not only do we find the 19s' ASW attractively tight in its own right, but the spread curve looks too flat (inverted) even relative to its level



Source: Bloomberg, Santander. Yield/yield spreads vs. 6m Libor.

Chart 60: GBP FRA/OIS basis remains much wider than at the start of this year, a widening we see as largely driven by the USD equivalent but perhaps also the end of the TFS



Source: Bloomberg, ICAP, BoE, Santander.

P.P.S.: Full remuneration of reserves is likely to outlive QE

The SMF comments at the end of the minutes were even less consequential, in our view, as they were broad and early indications of what the Bank might do, if and when the QE stock is run down. In our last review of this topic, back in September, we concluded that maintaining a 'floor' system seemed most likely, and the Bank is "minded" to agree.

The current MPC – probably a very different line-up to the one that would eventually make these decisions – is also anxious to avoid any uncomfortable contraction in the availability of bank reserves, so the BoE's balance sheet seems likely to remain large and liquidity ample indefinitely.

At the margin, this reassurance should logically warrant some FRA/OIS tightening, especially given their widening over recent months. That widening may have been influenced by the end of the Term Funding Scheme (TFS) and associated concerns that liquidity could be drained in future (Chart 60). On the contrary, the MPC seem to be emphasising that liquidity schemes such as repos are likely to be an increasingly important aspect of monetary policy if and when the BoE's assets start to contract.

But it must be admitted that this element of guidance is even vaguer than that on QE; is contingent on the (already highly contingent) reduction of QE; and therefore highly likely to only come into play after the end-2021 milestone when Libor is expected to be deprecated in favour of Sonia (and other RFRs). As a result, it currently seems to be of largely academic interest with no direct bearing on the market, although the signal may become important if market liquidity were ever to come more seriously into question.

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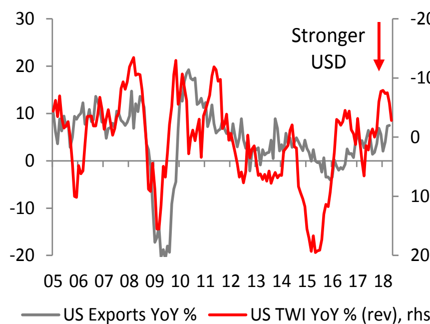
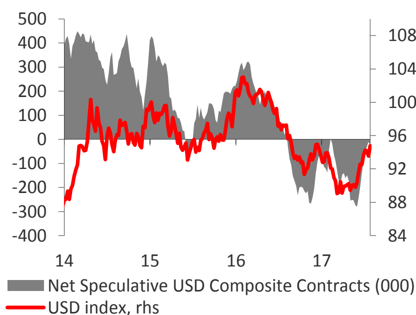
Taken from our latest FX Compass, published 22 June

Chart 61: Nothing to worry about yet, but a strong USD does not fit well alongside protectionist policies



Source: Bloomberg, Santander

Chart 62: USD has scope to reposition in either direction, but does a protectionist administration want a strong USD?



Source: CFTC, Bloomberg, Santander.

USD – Staying Strong

The USD remains firm. A robust economy, rising inflation and interest rate hikes are providing support and should continue to favour a firm currency. However, trade tension risk and an adverse impact on global trade could be viewed as USD negative factors. Plus, we wonder if a protectionist US administration would be prepared to allow the dollar to appreciate further.

The Fed's monetary policy should remain a USD support. As expected, US rates were increased in June, with the Fed funds target range increasing 25bp to 1.75-2.00%. Also, Fed Chair Jerome Powell adopted a more hawkish tone. He was upbeat on the economy, stating that activity was rising at a solid rate.

Indeed, the Fed revised upwards its near-term economic forecasts. It now expects GDP growth of 2.8% this year, up from 2.7%, and then 2.4% in 2019 and 2% in 2020. Unemployment is expected to reach 3.6% in 2018, compared with the previous estimate of 3.8% and slip again in 2019 and 2020 to 3.5%. Further, both headline and core PCE inflation estimates have been increased, to 2.1% and 1.9% respectively, for 2018, with both measures at 2.1% during the following two years. Powell added that 'further gradual' rate hikes would be consistent with sustained expansion of activity and CPI near the symmetric 2% target. Consequently, the Fed's dot charts, which provide a guide to FOMC member views on the appropriate interest rate level, were revised upwards by 25bp for both 2018 and 2019.

The dot chart revision now suggests that the Fed is likely to hike rates two more times in 2018, with three hikes coming in 2019. This is a slightly more bullish outlook for rates than has been priced in, and suggests that monetary policy divergence can keep the USD supported against currencies whose central banks we think are unlikely to hike rates in the near term, such as the JPY, CHF, GBP and NZD. However, by extension, that should imply USD losses versus the EUR and CAD, whose central banks are adopting a less accommodative stance.

Although the fundamental outlook is positive, rising trade tensions present a risk to activity that continues to impact FX sentiment. Traditionally, the USD is perceived as a safe-haven trade, sought after at times of economic or geo-political risk. But, this time around, the dollar had tended to be sold as risk appetite has faded. There appear to be several reasons for the turnaround in the relationship between the USD and risk: 1) the current risk is more USD-centric, namely President Trump's trade policy; 2) protectionism should undermine global growth, with a high performer like the US perhaps more at risk; and 3) similarly, slower growth could imply less need to hike rates, with the USD more at risk from a pricing out of US rate hikes.

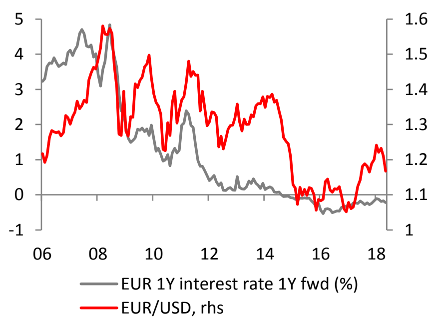
The USD could spend the summer in a tug of war between these potentially conflicting factors. A focus on rates should imply a strong USD, even if not across the board, whereas trade tensions risk dollar weakness. And, given that speculative position data show that 'fast money accounts' are broadly neutral on the USD, after being very negative in mid-April, there appears to be ample room for the USD to be pulled in either direction. But, for now, we suspect fundamentals and interest rates will win the day and keep the dollar firm over the coming months.

EUR – Too Pessimistic?

We have revised our EUR/USD forecasts lower but remain positive over the forecast horizon (see page 35). We feel that the EUR weakened too much following the June ECB meeting, and, although more US rate hikes in 2018 imply USD support, we suspect that these should now be priced in. We question whether a protectionist US administration will allow EUR/USD to sink further. In addition, we remain upbeat about the Eurozone economic outlook in 2019.

The EUR weakened significantly following the June ECB meeting. As expected, the bank signalled that it would taper its asset purchases in 4Q18 to €15bn a month from €30bn, ending the purchases completely at the end of the year. In line with many analysts, the ECB staff forecasts included a downward revision of 2018 GDP to 2.1% from 2.4% but an upward revision to the 2018 CPI forecast to 1.7% YoY from 1.4%. However, the bank did suggest that interest rates would remain at the current level 'at least through the summer of 2019', which was slightly longer than the consensus expected.

Chart 63: Confirmation that the ECB will exit its crisis-led monetary policy has not led to the EUR boost that we expected



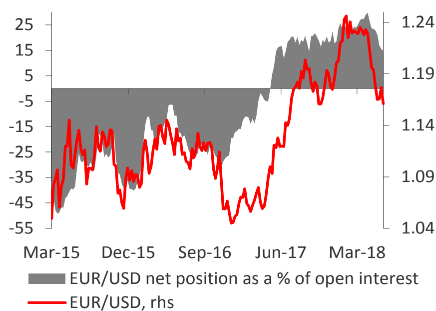
Source: Bloomberg, Santander

We had expected that the announcement of the end of QE would be EUR positive, as reducing the supply of something normally boosts its price. But the mix of the growth revision and interest rates lower for longer was the catalyst for a big drop in the EUR. Whilst this drop in spot implies a need for a technical correction to our forecast profile, there are factors that suggest the market may have overreacted to the ECB and that without further EUR negative news, the currency may be able to claw back some of this decline, albeit gradually.

First, timing may have worked against the EUR. The market may have gone into the Fed and ECB meetings expecting a dovish hike from the Fed and a hawkish hold from the ECB. But the Fed was more hawkish and the ECB more cautious. This may have meant that the market needed to reposition quickly against the EUR.

Second, we feel that the president of the ECB, Mario Draghi, did not clarify exactly what 'through the summer' meant, implying enough wriggle room to bring a rate hike forward. So again, the market may have overreacted in the short term. Third, whether a rate hike can be brought forward will depend on the data. The 2018 GDP revisions were notable, but as our economists highlight, it has to be placed in the context of disappointing 1Q18 data. Growth was softer than expected at the start of the year, affected by transitory factors that are now over.

Chart 64: Speculators remain net long EUR/USD for now



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

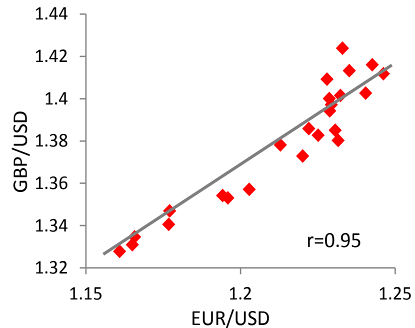
Indeed, we argued in the past that the EUR looked expensive in 1Q18, given that Eurozone economic data was surprising to the downside. But we still expect robust Eurozone growth in 2018, which after the EUR sell-off implies more scope for better than feared data to support the EUR. Plus, after the CPI revision, albeit thanks to oil, the ECB suggested that inflation is likely to remain around its current level, 1.9% YoY, for the remainder of the year.

Finally, whilst trade tensions risk undermining global demand, their impact on currencies appears increasingly ambiguous. At the start of the year, US warnings about tariffs were viewed as USD negative. But now with USD bulls in control, they may fuel a 'safe-haven' buying of the USD. Either way, we would question whether a protectionist US administration will sit quietly by and allow EUR/USD to plummet, potentially causing harm to US exporters.

GBP – Summer Frights

It has been a tough month for the pound. In the process, our year-end GBP/USD forecast of 1.32 was reached. We still believe that the pound got oversold in the months following the EU referendum and feel that a lot has already been priced in, which might provide some support. But ongoing Brexit uncertainty, a strong USD, disappointing UK data and a stable BoE imply that gains may be difficult to generate.

Chart 65: What matters for GBP/USD and EUR so far in 2018? Italy, ECB, Brexit, MPC, or simply the USD?



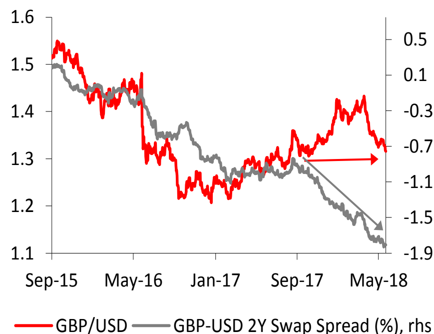
Source: Bloomberg, Santander. Note: Weekly data

Focussing on the movement in GBP/USD and EUR/GBP still highlights that, despite UK-specific factors, much of the movement in Cable can be explained by the movement in the USD. For example, since the start of the year, the correlation between EUR/GBP and the trade-weighted EUR has been 0.3, whilst the correlation between USD/GBP and the USD trade-weighted has been 0.95.

Admittedly, the pound has also performed poorly against the yen, as 'safe-haven' flows have helped the JPY. Meanwhile, EUR/GBP has proved relatively stable as a 'dovish' ECB has weighed on the EUR and both GBP/USD and EUR/USD have weakened amid dollar strength. So, with the USD remaining a key driver, Cable may only rally over the coming month if the USD declines.

At present, a USD decline looks unlikely. The market has, for now, jettisoned its concern about the US budget deficit and debt, with trade tensions now viewed as USD positive. Furthermore, whilst FOMC rate hikes did little to support the dollar in 1Q18, more Fed hikes, albeit already priced in, are helping the greenback.

Chart 66: Further interest rate divergence between the GBP and USD may merely imply Cable hanging around its recent levels



Source: Bloomberg, Santander

However, whilst the USD momentum remains key, the pound is receiving little help by way of UK-specific factors, a situation that is likely to continue over the summer. First, we expect economic underperformance to prevent any swift rebound in the pound. We expect UK GDP growth of 1.2% in 2018, compared to 2.8% in the US and 2.3% in the Eurozone.

The 1Q18 GDP data was weaker than expected, with growth at 0.1% QoQ. The BoE blamed poor weather for the data and expects a quick recovery in 2Q18. But weak manufacturing output in April (-1.4% MoM) casts some doubt on the pace of any second quarter recovery.

The BoE kept its policy on hold in June but the vote split was 6:3, compared to 7:2 at the last meeting. The market viewed the meeting as leaving the door open to an August rate hike, and the pound rallied. Inflation was unchanged at 2.4% YoY in May, and even though we expect it to rise to 2.6% YoY in June, we still do not expect the BoE to hike rates until 2020, which implies that the pound may be vulnerable to a reduction in rate hike expectations.

Further, Brexit uncertainty looks set to weigh on sterling sentiment. The EU Summit on June 28-29 looks unlikely to reach much of a conclusion on a future EU-UK relationship. Hence, we expect the focus to drift to the October summit.

Given these uncertainties, both political and fundamental, speculators may become increasingly willing to position against the pound. The IMM non-commercial GBP/USD position is currently broadly neutral, implying ample scope to open short GBP positions.

Table 7: G10 FX forecasts

	Q3 18	Q4 18	Q1 19	Q2 19	Q3 19	Q4 19
EUR-USD	1.19	1.21	1.23	1.24	1.25	1.26
GBP-USD	1.32	1.32	1.32	1.33	1.35	1.36
GBP-EUR	1.11	1.09	1.07	1.07	1.08	1.08
EUR-GBP	0.90	0.92	0.93	0.93	0.93	0.93
USD-JPY	117	118	120	120	120	118
EUR-JPY	139	143	148	149	150	149
USD-CNY	6.65	6.70	6.80	6.70	6.70	6.70
EUR-CHF	1.18	1.2	1.22	1.23	1.24	1.24
USD-CHF	0.99	0.99	0.99	0.99	0.99	0.98
EUR-SEK	9.9	9.6	9.5	9.5	9.3	9.2
EUR-NOK	9.4	9.3	9.1	9.0	8.8	8.7
USD-CAD	1.24	1.22	1.22	1.20	1.20	1.19
AUD-USD	0.76	0.77	0.79	0.80	0.79	0.78
NZD-USD	0.71	0.72	0.74	0.76	0.75	0.75

Source: Santander

Euro interest rate forecasts

Government Bond yield Forecasts

Bunds	Current	3Q18	4Q18	1Q19	2Q19	3Q19	4Q19
ECB Refi	0.00	0.00	0.00	0.00	0.00	0.30	0.50
ECB Depo	-0.40	-0.40	-0.40	-0.40	-0.40	-0.20	0.00
3m	-0.60	-0.65	-0.60	-0.55	-0.35	-0.20	-0.10
2y	-0.66	-0.35	-0.25	-0.10	0.00	0.25	0.45
5y	-0.29	0.05	0.20	0.45	0.65	0.85	1.00
10y	0.31	0.55	0.75	1.00	1.25	1.40	1.55
30y	1.03	1.10	1.25	1.50	1.80	1.90	2.05

Swap rate forecasts

€ swaps	Current	3Q18	4Q18	1Q19	2Q19	3Q19	4Q19
ECB Refi	0.00	0.00	0.00	0.00	0.00	0.30	0.50
ECB Depo	-0.40	-0.40	-0.40	-0.40	-0.40	-0.20	0.00
3m	-0.32	-0.33	-0.33	-0.29	-0.18	-0.02	0.21
2y	-0.17	0.10	0.15	0.25	0.30	0.55	0.75
5y	0.27	0.50	0.70	0.80	1.00	1.20	1.35
10y	0.88	1.00	1.15	1.35	1.60	1.75	1.90
30y	1.46	1.45	1.55	1.75	2.15	2.15	2.30

US interest rate forecasts

Government Bond yield Forecasts

USTs	Current	3Q18	4Q18	1Q19	2Q19	3Q19	4Q19
FOMC (mid)	1.875	2.125	2.375	2.625	2.875	2.875	2.875
3m	1.91	2.15	2.40	2.65	2.90	3.00	3.10
2y	2.52	2.80	3.05	3.25	3.40	3.50	3.60
5y	2.72	2.95	3.20	3.45	3.60	3.65	3.70
10y	2.84	3.05	3.25	3.45	3.60	3.70	3.80
30y	2.97	3.15	3.30	3.45	3.55	3.60	3.65

Swap rate forecasts

$ swaps	Current	3Q18	4Q18	1Q19	2Q19	3Q19	4Q19
FOMC (mid)	1.875	2.125	2.375	2.625	2.875	2.875	2.875
3m	2.34	2.55	2.75	2.95	3.15	3.20	3.25
2y	2.78	3.05	3.25	3.40	3.50	3.55	3.60
5y	2.87	3.05	3.25	3.45	3.55	3.55	3.60
10y	2.92	3.05	3.20	3.40	3.50	3.60	3.70
30y	2.91	3.05	3.20	3.35	3.40	3.45	3.50

UK Interest rate forecasts

Government Bond yield Forecasts

Gilts	Current	3Q18	4Q18	1Q19	2Q19	3Q19	4Q19
MPC	0.50	0.50	0.50	0.50	0.50	0.50	0.50
3m	0.60	0.45	0.40	0.45	0.45	0.46	0.48
2y	0.71	0.40	0.50	0.50	0.55	0.60	0.75
5y	1.01	0.75	0.90	1.00	1.20	1.50	1.60
10y	1.26	1.20	1.40	1.60	1.80	1.90	2.00
30y	1.72	1.70	1.80	2.00	2.20	2.40	2.50

Swap rate forecasts

£ swaps	Current	3Q18	4Q18	1Q19	2Q19	3Q19	4Q19
MPC	0.50	0.50	0.50	0.50	0.50	0.50	0.50
3m	0.67	0.65	0.55	0.55	0.55	0.56	0.58
2y	1.01	0.70	1.00	0.95	0.95	0.90	1.05
5y	1.29	1.05	1.25	1.30	1.45	1.70	1.80
10y	1.51	1.40	1.60	1.70	1.90	1.95	2.05
30y	1.60	1.50	1.40	1.65	2.00	2.10	2.20

FX forecasts

	Current	3Q18	4Q18	1Q19	2Q19	3Q19	4Q19
EUR-USD	1.164	1.19	1.21	1.23	1.24	1.25	1.26
EUR-GBP	0.886	0.90	0.92	0.93	0.93	0.93	0.93
GBP-USD	1.313	1.32	1.32	1.32	1.33	1.35	1.36
USD-JPY	110.6	117	118	120	120	120	118
EUR-JPY	128.7	139	143	147.6	148.8	150	149

	Current	3Q18	4Q18	1Q19	2Q19	3Q19	4Q19
NZD-USD	0.68	0.7	0.7	0.7	0.8	0.8	0.8
USD-CAD	1.325	1.24	1.22	1.22	1.20	1.20	1.19
AUD-USD	0.74	0.8	0.8	0.8	0.8	0.8	0.8
EUR-CHF	1.156	1.18	1.20	1.22	1.23	1.24	1.24
EUR-SEK	10.44	9.9	9.6	9.5	9.5	9.3	9.2
EUR-NOK	9.50	9.4	9.3	9.1	9.0	8.8	8.7

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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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