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# MACRO MARKETS DAILY

**ECB post-mortem:** As expected, and with an eye on the exchange rate, the ECB kept its message basically unchanged yesterday, with its tone being much closer to its previous meeting's than to Draghi's 'reflationary' comments in Sintra. Any discussion about a "QExit" was postponed until the autumn (interestingly, 7 September is considered "autumn" by the ECB). We continue to believe that, in September, the ECB will probably have to provide more information about tapering its bond purchases… but that it might be still too early for all the details about the ECB's QE Exit sequence. Please find our full post-mortem analysis on page 2.

## Economic data today

- **Spain May trade balance** (last -€1,199mn). The trade deficit at the end of April stood at €8.4bn vs. €5.6bn for the same period of 2016. But, in constant terms, the accumulated deficit was €9.7bn in April vs €12.3bn in Jan-April 2016, with nominal exports up 4.7% in this period (vs 1.7% in 2016), the strongest rise since 2011, thanks to productivity gains. Imports have grown by 4.2% in the 12 months to April 2017 (vs -0.2% in 2016). We expect the good performance of the Spanish external sector to continue in the coming years, providing support for GDP growth.
- **UK June Public Finances** (PSNB ex banks fcst. £5.6bn, last £6.7bn, Jun'16 £4.8bn). This is not typically a key month for the UK's public finances, so is unlikely to attract too much market interest. The picture is also clouded by the recent move to a new, smoother model for the monthly PSNB figures, which may still be throwing some forecasters off track.

## Rates Strategy

- **EUR rates:** After a relatively quiet morning, **volatility returned to the market with the ECB decision**. With the market expecting the ECB to somewhat retract the message delivered in Sintra, Draghi's press conference (where the prepared statement was not that different to that in June) was perceived by the market as more hawkish than expected and the initial market reaction sent both the EUR and EUR rates higher. Then, **during the Q&A session, Draghi tried to sound a bit more dovish**, remarking that the ECB will be in the market for "a really long time" and that the Bank remains prepared to make use of all the "flexibility of the programme".
- Interestingly, **the message did permeate the Rates market** (though not so much in FX), **particularly in periphery debt**. As a result, Spain and Italy saw their risk premia tighten 6-7bp vs. the 10y Bund, in a context where Germany also richened slightly on the day (around 1bp all along the curve). We highlight that Spain has left clearly behind the 100bp mark (95bp as we write) in spite of being active in the primary market (for €4.58bn) earlier in the day. In our view, **this move continues to highlight that**, now that the fiscal and political concerns are on the backburner, the combination of a stronger macro, tons of excess liquidity and negative depo (and repo) rates **should maintain periphery paper well supported** - see our SPGB auction preview, published on Wednesday, for a more detailed discussion.

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- Today, **a very light macro calendar is unlikely to dictate market sentiment**. Given that the UST proved a bit more stable overnight, the market will likely try to consolidate after yesterday's massive moves (so a slight correction is possible, even if only temporarily).
- On the **EUR sovereign ratings front**, S&P is scheduled to update its view on Greece (B, stable) and **Fitch its on Spain (BBB+, stable)** today. As explained in our SPGB auction preview, we see a case for Fitch to improve the outlook to positive, maybe as soon as today.
- **UK rates:** June's UK retail sales were slightly stronger than consensus although weaker than our forecast, but this was enough to give UK rates a mildly bearish tone throughout yesterday, in contrast to rallies in the EUR and US markets. 5y gilts were once again a very strong point in the wake of Wednesday's extremely high auction demand, the only area to widen vs. swaps and keeping up better with USTs and Bunds. Next Tuesday's 30y auction and Monday's (larger) coupons should be in clear focus from today. The 10s30s curve looks a little steep for the level of 10y yields, which –on top of the coupons, index extensions, and light supply calendar ahead– should bode well for the sale.
- **UK inflation:** A bad day for sterling despite the small nominal sell-off made a good day for breakevens, widening from 1.6bp (5y) up to 4bp (50y). This adds up to real yields ~10bp lower WTD, although breakevens have moved much less: up to 2.5bp tighter at the front end and about the same amount of widening from 30y+. We still look for the BEs around 10y to firm in the short run-up now the inflation release is behind us, with the IL26s 7-15bp cheap on regression versus 1H 26s.

## FX Strategy

- The **EUR** has held on to much of its post-ECB rally. The ECB press conference may not have provided much by way of new information in terms of the outlook for monetary policy or the timing of a likely tapering of QE, but the FX market still felt able to bid the currency higher as a result.
- Indeed, Draghi's comments, although conceding that Eurozone activity has improved, also made clear that there remained a need for policy to stay accommodative. However, his efforts to limit the EUR's gains were not successful, in our opinion, at least not for now. Hence, **EUR/USD** hit a high of 1.1658 and remained comfortably above 1.1600 in overnight trading.
- EUR/USD also continues to be helped by a soft USD and concern over US politics. However, we think the EUR/USD's advance and, for that matter, the **USD** sell-off may be a little overdone. This should make it harder for the EUR to appreciate from the current levels and may encourage some market participants to take profit on their long EUR positions. That said, it may take a move below 1.1479, Thursday's low, for short-term EUR sentiment to turn sufficiently bearish.
- A firmer EUR has pulled **EUR/GBP** close to 0.9000, but that level has not been breached yet, and looks like it will offer the cross strong resistance. Overall, Sterling has been an underperformer over the last week. GBP/USD is back below 1.3000, compared to Tuesday's high of 1.3126, providing some support for our view that, given UK economic jitters and Brexit concerns, a sensible strategy remains selling the Pound on rallies.
- The AUD was the big loser overnight. **AUD/USD** dropped below 0.7900, compared to a high of almost 0.8000 on Thursday. The catalyst for the sell-off was comments by RBA Deputy Governor Debelle, as he expressed some concern about the strength of the AUD and reduced expectations that the Bank may be willing to make near-term rate hikes.
- His concern about the effect of a strong currency, echoing worries previously expressed by the RBNZ, may spill over to other central banks given the weakness in the USD. To put things into perspective, the AUD has appreciated 9.6% against the USD since the start of the year, the NZD is up 7.1%, but the EUR has gained 10.6%.

## ECB postmortem: See you in September… or later

As expected, and with an eye on the exchange rate – trying not to scare the market again– the ECB kept its message basically unchanged, with its tone being much closer to its previous meeting's (highlighting the need for further accommodation, patience and confidence, and that the ECB will be in the market for a long time) than to Draghi's 'reflationary' comments in Sintra (27/6). Yet it seems the ECB did not have much success with the exchange rate.

We will therefore have to wait until its next meeting (7 September), which promises to be much more interesting as, together with a new round of macro projections, the ECB will probably have to provide more information about tapering its bond purchases in 2018. But, we continue to believe that even September might be too early for all the details on the ECB's QE Exit sequence (see our Macro, Rates, FX 2017 Year Ahead report), as it seems they did not discuss any of these aspects yesterday.

- ✓ The **Press Release** (Monetary policy decisions) following the announcement of unchanged official rates was a word-by-word carbon copy of last month's. So, it continued to say that the ECB expects interest rates "to remain at their present levels for an extended period of time, and well past the horizon of the net asset purchases" and that "if the outlook becomes less favourable" … and that it "stands ready to increase the programme in terms of size and/or duration." So, no hawkish tilt / further normalization in the statement.

- ✓ The **Full Statement of the Press Conference** did not add much information either, as Draghi repeated that: (1) the ongoing economic expansion provides confidence that inflation will gradually head to levels in line with the ECB's inflation aim, but it has yet to translate into stronger inflation dynamics; and (2) their economic analysis "confirmed the need for a continued very substantial degree of monetary accommodation" to secure a sustained return of inflation rates towards target ("the ECB will be in the market for a really long time").

- ✓ In the **Q&A session** Draghi was obviously grilled on the timing and conditions for the reduction in bond purchases beyond December, and on financial markets (mainly FX) after his comments at Sintra.

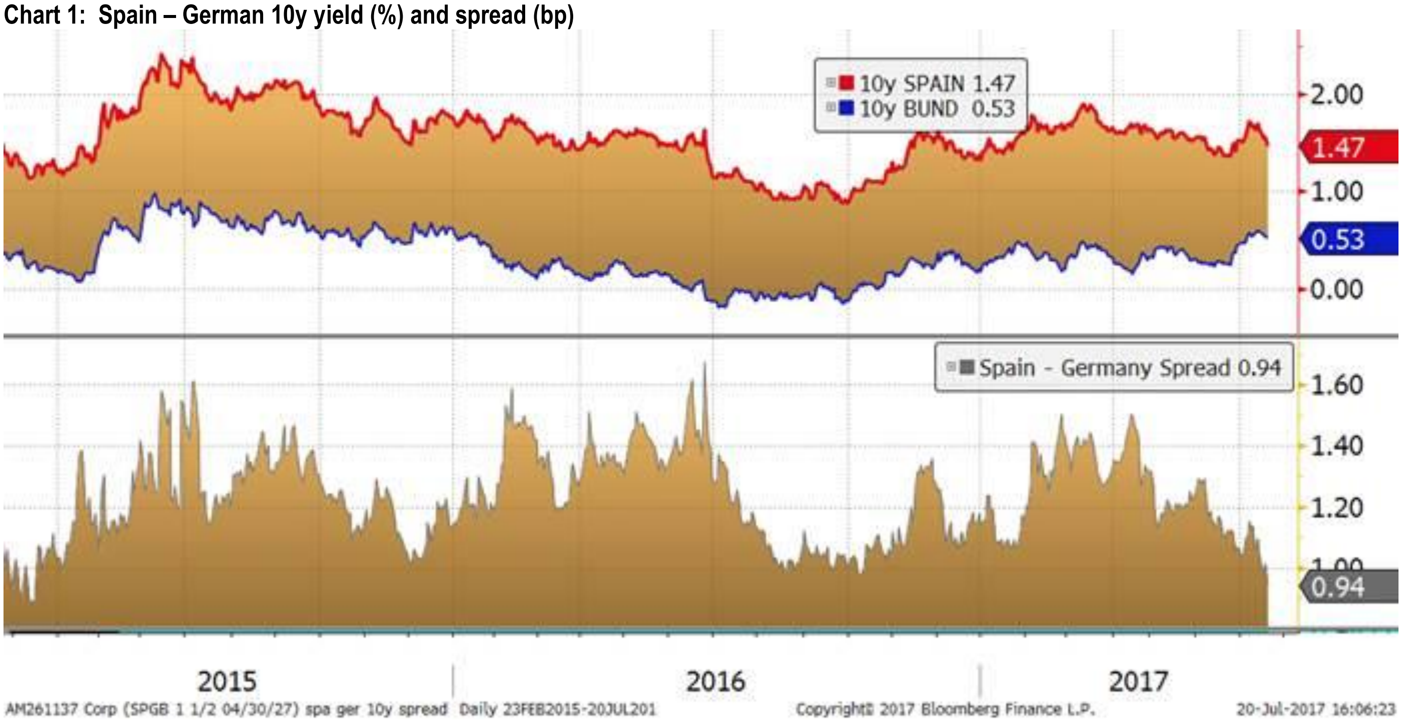
  - Regarding QExit, the ECB president repeated numerous times that the Council was "unanimous" in not discussing any aspect of the timing, conditions or speed of the reduction in bond purchases, postponing that discussion to the autumn (interestingly, 7 September is considered "autumn" by the ECB).

  - On the latter, Mario Draghi recalled that the ECB's only target is inflation, and that tighter financial market conditions could endanger or postpone achieving that (only) goal in the shortest possible period. In fact, as he added that the ECB maintains its dovish bias, Draghi seemed to be –unsuccessfully– trying to avoid further EUR strength.

- ✓ **Market reaction:** Interestingly, while the EUR spiked higher as the press conference started (at the time of writing it is trading at c.$1.165, clearly above Tuesday's level of $1.158), EUR rates, although volatile, performed quite well especially on the periphery (10y SPGB yield -8bp to1.48%, despite the SPGB auction, with BTPS enjoying a similar rally but Bunds barely moving).

  Accordingly, the Spanish 10y-Bund spread consolidated below 100bp (95bp at the time of writing), its tightest level in more than two years (see Chart 1). So, while the huge excess liquidity (€1.7trn) and ongoing ECB purchases (+ rich valuations in most financial markets) mean investors are still desperately looking for high-quality yield, the EUR exchange rate, helped by Theresa May's and Donald Trump's domestic problems, can probably continue grinding higher (towards our bullish targets).

**Chart 1: Spain – German 10y yield (%) and spread (bp)**




Source: Bloomberg, Santander.

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