26 July 2017, 08:40 CET

MACRO MARKETS DAILY

Economic data today

- **France July Consumer Confidence** (last 108). Consumer Confidence in June jumped to its highest reading since June 2007, clearly outperforming expectations, and in a context of a significant decline in unemployment being anticipated. That said, consumer confidence has probably been positively influenced by the end of political uncertainty in the country, although the labour market recovery is also very important in boosting households' optimism.
- **Spain June Retail Sales** (last 2.4% YoY). Both the headline figure and the breakdown for retail sales in May were quite robust, with personal equipment at 7.4% YoY, household equipment at 4.9% YoY, food at 3.2% YoY and other goods at 1.5% YoY. In other words, these data are consistent with our consumer spending forecast of 0.8% QoQ in 2Q17E from 0.4% QoQ in 1Q17.
- **US June New Home Sales** (last 2.9% MoM, exp. 0.8% MoM). Home sales in the US could have slowed in June after the strong rebound in May. Note that new home sales have surged by 100% since the all-time lows recorded in September 2011, but are still 54% below the peak posted in 1Q15. Median sales prices are, however, at historical highs, and this could limit the growth rate for new home sales.
- **UK 2Q17 GDP, first estimate** fcst. 0.3% QoQ / 1.7% YoY, 1Q17 0.2% QoQ / 2.0% YoY), May Index of Services (fcst. 0.1% MoM, last 0.2% MoM). Our forecasts are in line with consensus, and consistent with the UK economy operating slightly below its potential rate of expansion. Please see page 3 for a discussion of the factors behind today's release.

Rates Strategy

- **EUR rates:** The selling pressure on the TY future (where two large block sales were reported at the end of the European morning) quickly spread to the spot market, causing the belly and long end of the EUR govie curves to sell off (in tandem with its peers in the UK and the US). Interestingly, as has been the case over the past few weeks, the sell-off in the core did not trigger any clear widening trend in risk premia, further supporting our call of the periphery remaining strong (at least in relative value vs. core), buoyed up by the search for yield caused by the combination of an improving macro backdrop and superlative excess liquidity.
- We expect all eyes to be on the **FOMC meeting today**. As explained in detail in our preview (page 2), we believe that the risk of a significant market reaction to the FOMC outcome is very limited today, and that the release of the FOMC statement should prove quite market neutral, as we do not expect it to provide any clear hints as to what to expect in September. We expect the Minutes (published in three weeks) or even the Jackson Hole symposium (a week later) to be much more interesting, from a market perspective.
- **Debt supply:** Greece successfully placed €3bn of the new 5y benchmark, after receiving around €6.5bn in orders. Today, Italy is selling €1.5-2.0bn of 2y CTZs (due May'19) and €0.75-1.25bn of 10y BTP€is (due May'28).

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

José María Fernández
Rates Strategist
josemariafernandezl@gruposantander.com

Edgar da Silva
Rates Strategist
efda@gruposantander.com

Banco Santander, S.A.
(+34) 91 257-2244

Antonio Espasa
Chief Economist
aespasa@gruposantander.com
(+34) 91 289-3313

Laura Velasco
Economist
laura.velasco@gruposantander.com
(+34) 91 175-2289

Beatriz Tejero
Economist
beatriz.tejero@gruposantander.com
(+34) 91 257-2410

Banco Santander, S.A

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

Stuart Green
UK Economist
Stuart.Green@santandergcb.com

Adam Dent
UK Rates Strategist
adam.dent@santandergcb.com

Banco Santander, S.A. London Branch
(+44) 20 7756-4111 / 6170 / 6223

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

Michael Flisher
G-10 FX Strategist
michael.flisher@santandergcb.com

Banco Santander, S.A. London Branch
(+44) 20 7756-4136 / 5799

**For a full list of contributors, please refer to the Analyst Certification section*

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

- **UK rates:** Good macro data on all fronts gave global rates a very bearish session yesterday, with 10y gilts and USTs both closing 7bp higher in yield. There were even some upbeat data in the UK, with the CBI Business Optimism balance up to +5 from +1 at the end of Q1. Perhaps more significantly for the MPC's focus on inflation, the CBI's Selling Prices indicator declined unexpectedly sharply, from +23 to +9 (its lowest since October), and YouGov/Citi consumer inflation expectations for the year ahead fell slightly on the month. Demand was extremely good at the 30y gilt auction, and 10s30s flattened 1.5bp over the day, a trend that we see as likely to extend as month-end and 10y auctions approach. UK GDP should be the market's focus today, but we would caution against putting too much weight on any surprises reported in the first estimate, as noted on page 3. Indeed, the ONS itself wants to change the GDP release schedule from this time next year (consultation details here), delaying the first estimate to six weeks after quarter-end, so that a more complete picture is available to reduce "see-sawing" in the economic narrative.
- **UK inflation:** Linkers outperformed yesterday, regardless of those low-profile price expectation surveys and a slight strengthening of the currency. Oil in charge, perhaps, with a 2.88% rise in Brent (in USD terms)? Front-end breakevens rose ~3bp, 1-2bp more than mechanically implied by the nominal sell-off, whereas apparent profit-taking in the long end capped their widening to <1bp, effectively a slight tightening once beta-adjusted. 10y linkers still look cheap to us on regression, even after the last week of outperformance.

FX Strategy

- **AUD/USD** weakened overnight, dropping to 0.7900 after the Q2-17 CPI data disappointed. The annual headline print was expected to rise (to 2.2%, from 2.1%), but actually fell to 1.9%, dropping below the RBA's 2-3% target range. RBA Governor Lowe stated, shortly after the release, that the RBA does not need to move in lockstep with its global peers. Hence, we continue to expect the Bank to keep rates on hold for at least the next 12 months, which should encourage a weaker AUD, especially if other central banks begin to tighten their monetary policy.
- The **USD Index** was a little firmer overnight, holding above 94.00 ahead of tonight's FOMC meeting. Meanwhile, **USD/JPY** returned to 112.00 overnight, with the BoJ's Nakaso emphasising that the Bank will persist with its current powerful easing, and that it is crucial to continue to aim for 2% inflation.
- **EUR/USD** briefly touched above 1.1700 yesterday, its first time above this level since August 2015. However, the Single Currency struggled in the afternoon, after the IMF urged the ECB to maintain stimulus amid downside risks to growth. The pair has now slipped below 1.1650. There are no data of note to lead EUR/USD today, leaving the market to position, instead, for tonight's FOMC Press Release.
- **GBP/USD** rallied to 1.3080 yesterday, but has now unwound this move, with the pair back at 1.3020 this morning. The UK focus today will be on the latest GDP data. The Q2-17 numbers are expect to show limited growth, of just 0.3% QoQ, with the annual print slipping to 1.7% (from 2.0%). If growth numbers do weaken, that should weigh on expectations for a UK rate hike. In fact, with the market pricing over a 40% chance of the BoE hiking rates this year, weak growth data could prompt a rethink of this view, which could weigh on Sterling in turn.

FOMC preview: Move along, nothing to see here…

All eyes will be on the US today, with the FOMC announcing its monetary policy decision this evening. However, with no press conference being held with Janet Yellen and no update of the macro projections, we believe the official statement is **unlikely to provide any real insight that might move market expectations significantly**. Rather, we expect the Minutes (to be published in three weeks) or even the Jackson Hole symposium (a week later) to be much more interesting, from a market perspective.

On the macro front, there has been little in the way of challenging news in the past few months. Most indicators anticipate a recovery in activity in the US in Q2, which should be confirmed by the first estimate of the country's GDP this Friday. And the labour market remains solid, with job creation ongoing. But inflation is still failing to pick up and there is no clear upward pressure in wages, hence placing the Fed in a situation where it should feel **comfortable about the US economy, but not confident enough to increase the pace of tightening**.

From a market perspective, oil at current levels should translate into a mostly neutral base effect on inflation from energy prices over the next few months, while the fast weakening of the USD should allow the Fed to be a bit more confident about the macro outlook in the medium term, and give it some extra room to turn more hawkish in the short run (as they could now cope with some slight USD appreciation better than just three months ago).

In this connection, **we continue to believe that the market is underpricing the tightening from the Fed over the next few quarters**, and that the Fed will try to redirect market expectations closer to its own projections at some point. **But there is no reason to think that the Fed will be in a hurry to do so in this very meeting**, when the members can only use official statement (no press conference / macro projections) to express their views.

It would probably take a rebound in the inflation numbers (particularly core CPI) or the Fed explicitly stating that starting its balance sheet reduction is fully compatible with a faster pace of hikes than the market is pricing to prompt a repricing in monetary policy expectations.

- The timing of the former does not depend, directly, on the Fed. And the next round of CPI data is released in three weeks' time.
- As regards the latter, **there is a chance that the Minutes to this meeting (16 August) or even Jackson Hole (24-26 August) could provide some insight** into the Fed's expectations around the impact of slimming its balance sheet on its monetary policy stance and, hence, into any potential changes in the expected pace of hikes in the next few quarters.

Therefore, we believe that the risk of a significant market reaction to the FOMC outcome is very limited today, and that the release of the FOMC statement should prove quite market neutral, as we do not expect it to provide any clear hints as to what to expect in September. That might change in August, especially if the inflation numbers start to improve, but not quite yet.

UK Economics: Another sub-par GDP figure expected for Q2

Although speculation around the outcome of the August Bank of England Monetary Policy Committee (MPC) meeting has subsided over the past week, this morning's release of the preliminary estimate of the UK's Q2 GDP will still be keenly awaited by the market, given growing concerns around the near-term UK growth outlook. In line with the consensus expectation, we look for a 0.3% increase in GDP to be registered for Q2, which would equate to a 1.7% year-on-year rise. This would be slightly ahead of the 0.2% quarterly pace seen in Q1, but below the MPC's central forecast (0.4% q-o-q), and consistent with our view of the UK economy operating slightly below its potential rate of expansion.

As is always the case at the current stage of the release cycle, a number of assumptions have to be made with regard to activity during the final stages of the quarter, in order to a generate headline GDP forecast, and we would stress that, at present, only c44% of the information that will ultimately be known for Q2-17 is currently available to the Office of National Statistics (ONS). We assume a 0.3% increase in industrial production in June, following a small rise and then a fall in April and May, respectively, and we also assume that construction output grows by 1.1% in June, following on from similarly-sized declines being registered in both April and May. Although this appears a somewhat ambitious assumption with regard to construction output in June, we would stress that this remains one of the most volatile components of the GDP data, and we have also noticed a tendency for the final months of recent quarters to bring better news from the industry.

Even our relatively upbeat assumptions for June, however, would fail to prevent declines in both industrial and construction activity being registered for Q2 as a whole (save for some very large revisions being applied to the April and May data). Our forecasts look for industrial production to have fallen by roughly 0.4% over the quarter, which, if confirmed, would reduce Q2 GDP growth by 0.06%-pts, while we estimate a 1.5% fall in construction output for Q2 as a whole, which again (if confirmed) would reduce quarterly GDP growth by 0.09%-pts.

Our forecast for a 0.3% rise in GDP as a whole therefore rests upon the services sector, where we expect monthly increases in output of 0.1% to be reported for both May and June. If confirmed, this would see the sector contributing 0.48%-pts to GDP growth overall. We calculate that the observed weakness of retail sales volumes in May (-1.5% m-o-m ex-auto fuel basis) and subsequent recovery in June (+0.9%) will subtract 0.1%-pt from the index of services in May, before adding 0.06%-pt in the following month. As such, our forecast for a 0.1% rise in services output in June could be viewed as slightly conservative. But, with a variety of business activity surveys having deteriorated in June –including the business expectations component of the services PMI dropping to its lowest since December 2011 (abstracting from the fall in confidence which immediately followed the EU referendum result)– we still believe that the services sector was experiencing only a weak level of momentum at the end of the second quarter.

Important Disclosures

ANALYST CERTIFICATION:

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

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

EXPLANATION OF THE RECOMMENDATION SYSTEM

DIRECTIONAL RECOMMENDATIONS IN BONDS		DIRECTIONAL RECOMMENDATIONS IN SWAPS	
Rating	**Definition**	**Rating**	**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.	**Long / 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.	**Short / 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	
Rating	**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	
Rating	**Definition**
Long / Buy	Appreciation of a given currency with an expected return of at least 5% in 3 months.
Short / Sell	Depreciation of a given currency with an expected return of at least 5% in 3 months.

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

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

IMPORTANT DISCLOSURES

This report has been prepared by Banco Santander, S.A. and is provided for information purposes only. Banco Santander, S.A. is registered in Spain and is authorised and regulated by Banco de España, Spain.

This report is issued in the United States by Santander Investment Securities Inc. ("SIS"), in Spain by Banco Santander, S.A., under the supervision of the CNMV and in the United Kingdom by Banco Santander, S.A., London Branch ("Santander London"). SIS is registered in the United States and is a member of FINRA. Santander London is registered in the United Kingdom (with FRN 136261, Company No. FC004459 and Branch No. BR001085), and subject to limited regulation by the UK's Financial Conduct Authority ("FCA") and Prudential Regulation Authority ("PRA"). SIS, Banco Santander, S.A. and Santander London are members of Santander Group. A list of authorised legal entities within Santander Group is available upon request.

This material constitutes "investment research" for the purposes of the Markets in Financial Instruments Directive and as such contains an objective or independent explanation of the matters contained in the material. Any recommendations contained in this document must not be relied upon as investment advice based on the recipient's personal circumstances. The information and opinions contained in this report have been obtained from, or are based on, public sources believed to be reliable, but no representation or warranty, express or implied, is made that such information is accurate, complete or up to date and it should not be relied upon as such. Furthermore, this report does not constitute a prospectus or other offering document or an offer or solicitation to buy or sell any securities or other investment. Information and opinions contained in the report are published for the assistance of recipients, but are not to be relied upon as authoritative or taken in substitution for the exercise of judgement by any recipient, are subject to change without notice and not intended to provide the sole basis of any evaluation of the instruments discussed herein.

Any reference to past performance should not be taken as an indication of future performance. This report is for the use of intended recipients only and may not be reproduced (in whole or in part) or delivered or transmitted to any other person without the prior written consent of Banco Santander, S.A..

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

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

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

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

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

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

ADDITIONAL INFORMATION

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

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

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

COUNTRY & REGION SPECIFIC DISCLOSURES

U.K. and European Economic Area (EEA): Unless specified to the contrary, issued and approved for distribution in the U.K. and the EEA by Banco Santander, S.A. Investment research issued by Banco Santander, S.A. has been prepared in accordance with Grupo Santander's policies for managing conflicts of interest arising as a result of publication and distribution of investment research. Many European regulators require that a firm establish, implement and maintain such a policy. This report has been issued in the U.K. only to persons of a kind described in Article 19 (5), 38, 47 and 49 of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (all such persons being referred to as "relevant persons"). This document must not be acted on or relied on by persons who are not relevant persons. Any investment or investment activity to which this document relates is only regarded as being provided to professional investors (or equivalent) in their home jurisdiction. **United States of America (US):** This report is being distributed to US persons by Santander Investment Securities Inc ("SIS") or by a subsidiary or affiliate of SIS that is not registered as a US broker dealer, to US major institutional investors only. Any US recipient of this report (other than a registered broker-dealer or a bank acting in a broker-dealer capacity) that would like to effect any transaction in any security or issuer discussed herein should contact and place orders in the United States with the company distributing the research, SIS at (212) 692-2550, which, without in any way limiting the foregoing, accepts responsibility (solely for purposes of and within the meaning of Rule 15a-6 under the US Securities Exchange Act of 1934) under this report and its dissemination in the United States. US recipients of this report should be advised that this research has been produced by a non-member affiliate of SIS and, therefore, by rule, not all disclosures required under NASD Rule 2711 apply. **Hong Kong (HK):** This report is being distributed in Hong Kong by a subsidiary or affiliate of Banco Santander, S.A. Hong Kong Branch, a branch of Banco Santander, S.A. whose head office is in Spain. The 1% ownership disclosure satisfies the requirements under Paragraph 16.5(a) of the Hong Kong Code of Conduct for persons licensed by or registered with the Securities and Futures Commission, HK. Banco Santander, S.A. Hong Kong Branch is regulated as a Registered Institution by the Hong Kong Monetary Authority for the conduct of Advising and Dealing in Securities (Regulated Activity Type 4 and 1 respectively) under the Securities and Futures Ordinance. The recipient of this material must not distribute it to any third party without the prior written consent of Banco Santander, S.A. **Japan (JP):** This report has been considered and distributed in Japan to Japanese-based investors by a subsidiary or affiliate of Banco Santander, S.A. - Tokyo Representative Office, not registered as a financial instruments firm in Japan, and to certain financial institutions defined by article 17-3, item 1 of the Financial Instruments and Exchange Law Enforcement Order. Some of the foreign securities stated in this report are not disclosed according to the Financial Instruments and Exchange Law of Japan. There is a risk that a loss may occur due to a change in the price of the shares in the case of share trading and that a loss may occur due to the exchange rate in the case of foreign share trading. **China (CH):** This report is being distributed in China by a subsidiary or affiliate of Banco Santander, S.A. Shanghai Branch ("Santander Shanghai"). Santander Shanghai or its affiliates may have a holding in any of the securities discussed in this report; for securities where the holding is greater than 1%, the specific holding is disclosed in the Important Disclosures section above.

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

Local Offices

Madrid Tel: 34-91-257-2035 Fax: 34-91-257-0252	**Lisbon** Tel: 351-21-389-3400 Fax: 351-21-387 0175	**London** Tel: 44-870-607-6000 Fax: 44-20-7332-6909	**Milan** Tel: 39-02-8542-09810 Fax: 39-02-8606-71648
Brussels Tel: 32 2 286 5447 Fax: 32 2 230 6724	**Paris** Tel: 33 15353 7000 Fax: 33 15353 7060	**Frankfurt** Tel: 49 6959 67-6403 Fax: 49 6959 67-6407	**Tokyo** Tel: 813-5561-0591 Fax: 813-5561-0580
New York Tel: 212-756-9160 Fax: 212-407-4540	**Bogota** Tel: 571-644-8008 Fax: 571-592-0638	**Buenos Aires** Tel: 54114-341-1052 Fax: 54114-341-1226	**Caracas** Tel: 582-401-4306 Fax: 582-401-4219
Lima Tel: 511-215-8133 Fax: 511-215-8161	**Mexico DF** Tel: 525-629-5040 Fax: 525-629-5846	**Santiago de Chile** Tel: 562-336-3300 Fax: 562-697-3869	**São Paulo** Tel: 5511-3012-5721 Fax: 5511-3012-7368