

MACRO MARKETS DAILY

Economic data today

- **US May Trade Balance** (exp. US\$-46.3bn, last US\$-47.6bn). The trade deficit widened in April due to the fall in exports and rise in imports. At the end of the day, we continue anticipating a clear reactivation of US GDP growth for 2Q17E, even with a negative contribution from the net external sector in the quarter, courtesy of the rebound in imports. **June ISM Non-manufacturing Composite** (exp. 56.5, last 56.9). Services sentiment remains at historically high levels, all in all, indicating an economy that, according to our estimates, could grow at an average pace of c2.5% QoQa over the remainder of the year.
- **The ECB releases its account of the June monetary policy meeting.**
- **Central bank speakers:** The Fed's Williams and Powell, as well as the ECB's Praet, Weidmann and Nowotny.

Rates Strategy

- **EUR rates:** Yesterday was another day of mixed performances in the European bond market as investors awaited, first, the publication of the FOMC meeting minutes last night, second, the release of the ECB accounts this afternoon and, third, the June NFP figures in the US tomorrow. At yesterday's close, 10y Bund yields were little changed, still above the 0.45% mark (0.467%), while the 10y OAT performed similarly, with its yield dropping marginally (-0.5bp to 0.813%) as the *Agence France Trésor* prepares to sell debt midmorning. In periphery risk spreads versus Bunds, Portugal was the outperformer again, with its 10y spread dropping to slightly below the 245bp mark, its tightest since January 2016. For its part, Spain's 10y spread fared slightly better than Italy's (+4.1bp to 108bp and +4.2bp to 166bp, respectively), both of which had touched their lowest levels of the last five months on Monday.
- **Today**, given the lack of significant macro data in Europe, markets will be focusing on Fed (Williams and Powell) and ECB (Praet, Weidmann, and Nowotny) speakers during the day, while awaiting the release of the ECB accounts, and discounting the details in the FOMC Minutes.
- In **supply terms**, today, **Spain** is active in the bond market for the first time in July, offering up to €4bn of the 0.4% Apr'22, 4.9% Jul'40 and 2.9% Oct'46 SPGBs and up to €1bn of the Nov'30 linker. From an RV perspective, we find the Apr'22 the most appealing of the three SPGB references being tapped, as it is trading cheaper than its immediately neighbours, according to our yield curve model. And the Jul'40 and Oct'46 SPGBs currently offer good RV trade opportunities in their respective sectors (please see yesterday's [Auction Preview](#) for more details of this auction). Later in the morning, **France** will be tapping two 10-year bonds (1% May'27 and 2.75% Oct'27 OATs) and its 30y OAT (2% May'48) for up to €8.5bn, wrapping up the Euro area supply week.
- **FOMC Minutes post-mortem:** The Minutes to the June FOMC meeting, released yesterday, provided some insight into the possible timing of the start of the Fed's balance sheet reduction measures, as well as some colour on the FOMC members' views about the potential impact of such measures on the expected pace of rate hikes. Starting with the timing,

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"several" members called for an announcement "within a couple of months", although "some others" preferred to wait until "later in the year" to better assess the outlook for inflation and economic growth. As regards the impact on future rate hikes, "several" members believed that the pace of hikes should be "less steep" than previously anticipated, while "some others" did not see these measures as affecting the pace of hikes, and "a few" considered that the impact on monetary policy firming would only be "modest". We read these messages as being fully consistent with a Fed announcement in September that SOMA reinvestments will begin to be phased out during 4Q17, with such measures only "eroding" a small fraction of the future hikes currently suggested by the dot chart (along the lines of the three hikes for the period to December 2019 that we infer from the model proposed by the Kansas Fed – see our latest [Interest & Exchange monthly report](#) for a broader discussion on this topic).

- **UK rates:** Steepening was the tone yesterday, in contrast to bull-flattening in the US after its holiday. The session started with a tentative sell-off, which reversed after the Services PMI completed a weak set in the UK. 2-6y gilts all rallied by up to 2bp, whereas 10y lost over 1bp and the long end an additional 1-2bp. GBP swaps showed a similar pattern but with less strength in the front end, widening 2-6y ASW by 2bp and leaving 10y+ mixed but little changed; 30y were the best performing spreads in that end. Any reversal of June's sharp cheapening remains tentative, which we believe now creates a good opportunity to buy – see page 3 for more analysis.
- **UK inflation:** Linkers sold off across the curve, by a fairly even 3.4-4bp from 10y onwards. This meant a particular squeeze on 5y breakevens (IL22s' - 3.2bp), weighed down by both the reversal in the oil price recovery and the bid for short nominals. Ultra BEs were again surprisingly little changed (-0.8bp) in the countdown to the IL56s' sale, but their real yields reaching six-month highs (-1.46%) should have done enough to drum up demand.

- **UK supply:** The DMO will auction £2.5bn of the 1.25% July 2027 gilt this morning, with a DV01 around £2.3mn. Please see yesterday's [Auction Preview](#) for full details. We are bullish on UK rates overall after the recent MPC-driven sell-off, and 10y gilts in particular as they led the way cheaper (see page 3). Net gilt supply is strongly negative over this quarter, which should be supportive for gilts in general and adds to our bullish bias. This bond remains attractive on RV versus the old 27s, and we now also see value vs. the 2% 25s

FX Strategy

- The USD was stable in overnight trading, albeit off of Wednesday's highs, as the market digested the content of the June FOMC Minutes. Hence, not much by way of change for G10 FX, with AUD/USD garnering some support from better-than-expected Australian trade data for May, but the Yen slightly weaker as Japanese equities softened.
- In terms of the Minutes, USD bulls may have taken comfort from the view that at least one more rate hike appears to be on the cards for H2-17. However, concern over subdued inflation pressures and an apparent difference of opinion as to how quickly the Fed should shrink its balance sheet weighed on the dollar.
- The central bank focus now turns to the publication of the 'account' of the last ECB meeting. If the account supports comments made by the ECB's Coeure yesterday, namely that the ECB Governing Council has not discussed policy changes, the EUR should weaken. In this case, an immediate target would appear to be yesterday's low at 1.1313, closely followed by the 28 June low at 1.1292.
- Sterling was a marginal outperformer during Asian trading, with EUR/GBP testing levels below 0.8760. GBP/USD has also picked up, with a test of 1.3000 still possible, even though the pair was unable to break yesterday's high at 1.2948 overnight. Support is still seen around its 55-day moving average, now at 1.2872.



UK trade idea – buy 10y gilt outright

As noted above and in our Auction Preview yesterday, we are bullish on UK rates and feel the time has come to take the plunge and buy now the market has caught its breath after the volatility of late June. Short rates are a natural way to lean against the market's (in our view, premature) perception of MPC hawkishness, but the whole market has moved together and longer tenors can be just as appropriate, in our view. In the very short end, we still see the 'elbowing' of the front end as too extreme (Chart 1), and continue to recommend fading it through receiving the belly of flies such as 1y/1y1y/2y1y (since [22 June](#)), or (even more bullishly) 1y/1y1y flatteners

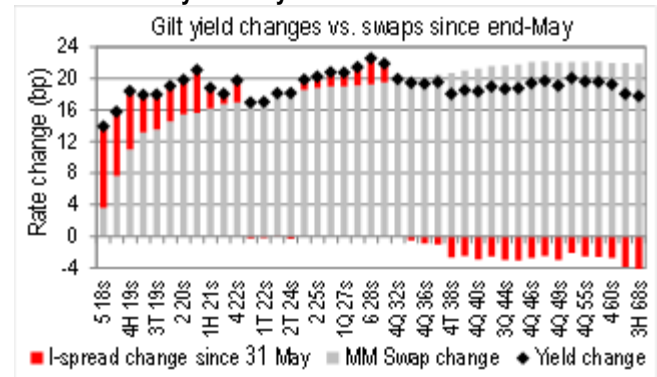
Chart 1: Very short GBP rates have steepened much more sharply than slightly longer dates, compared to previous episodes



Source: Bloomberg, Santander.

Term rates have also sold off strongly, hitting both front-end and ~10y gilts particularly hard (Chart 2), with the liquidity of the gilt future acting as a lightning rod for that sector. The 3T 20s, in particular, stand out as having cheapened against their neighbours and swaps, but, in outright terms, we find their 0.34% yield and -41bp y/y swap spread (still the widest of all) make for an unattractive carry proposition.

Chart 2: Front-end and 8-12y gilts have underperformed in the sell-off, while the long end has outperformed swaps despite the imminent 40y linker syndication



Source: Bloomberg, Santander.

This leaves us with the 10y region of the gilt curve as our preferred positioning for a reversal of the sell-off, plus the supportive gilt supply environment over the summer (see our Auction Preview or [Govie Supply Weekly](#) for details). The 28s and 30s have sold off even more than the 27s, but we see arguments against them: the illiquidity of the 28s and the rich starting point of the 30s (we recommended extending from the 30s into the 32s on [17 Feb](#); that pair is now roughly back where it started after spending three months even steeper, and we see the 32s as likely to keep outperforming them).

Historical betas have been pretty unreliable of late, but the 2-3y and 40y regions look to have cheapened too much relative to 10y on those relationships. We have already mentioned the carry deterrent in the front end, although they could be appealing for a short-run dovish play, perhaps into next Wednesday's wage data. We believe 40y is set up to perform well after next week's linker syndication, although September's conventional one may keep a cloud over that sector.

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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.
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