

MACRO MARKETS DAILY

Economic data today

- **Spain May Industrial Production** (exp. 2.0% YoY, last 0.7% YoY). The solid bases for both domestic and foreign demand reinforce an upward trend for the sector in coming quarters. **Italy May Retail Sales** (exp. 0.3% MoM and 1.0% YoY, last -0.1% MoM and 1.2% YoY). Companies' upbeat views should favour an improvement in the labour market that could translate into a surge in consumer confidence and spending.
- **France May Trade Balance** (exp. €-5,100mn, last €-5,535mn). We anticipate a recovery in trade flows, all in all, with the net external sector contributing a positive c0.5pp to GDP expansion in 2Q17E (vs -0.6pp in 1Q17). **May Industrial Production** (exp. 0.6% MoM and 1.4% YoY, last -0.5% MoM and 0.6% YoY). Confidence in the sector surprised positively in June, thanks to the increase in new orders. As a result, French manufacturers reported some pressure in terms of capacity, indicating good production performance.
- **UK May Industrial Production** (fcst. 0.3% MoM, last 0.2% MoM), **Manufacturing Output** (fcst. 0.3% MoM, last 0.2% MoM), **Construction Output** (fcst. 0.5% MoM, last -1.6% MoM). On the face of it, we are forecasting a reasonable pick-up in activity in May. But the activity profile over the first four months of the year has set a large hurdle for the second quarter just to post flat QoQ growth: April IP was 0.4% and Construction 1.5% below their Q1 average levels, leaving plenty to be done in June even if May comes in as we expect. Revisions to those prior months will be particularly important to watch for Construction, as usual.
- **US June Nonfarm Payrolls Change** (exp. 177k, last 138k). Despite May's disappointing headline pace of job creation, the full report was better. The slowdown in employment creation essentially came from household employment. Average hourly earnings growth stood at 2.5% YoY, the number of jobless dropped by 195k and the U6 jobs (part-time for economic reasons) fell to 8.4%, the lowest since September 2007. All in all, we expect a clear reversion of this downward trend in the pace of job creation shortly.
- **Central bank speakers:** The BoE's Carney is attending the G20 today and Cunliffe a conference panel tomorrow, but neither will be making a published speech.

Rates Strategy

- **EUR rates:** The sell-off in EUR govies accelerated yesterday, as the 10y JGB breaching the 0.10% mark for the first time since February helped the 10y Bund not only break through the 0.5% level, but indeed extend losses for the rest of the session, finally closing at 0.56% (+9bp on the day). Curve-wise, the bulk of the move took place in the 5y tenor (2s5s steepening 4bp in the swap curve yesterday). So, 2s5s on the German curve are now 16bp steeper than one week ago, but 5s10s 4bp flatter. This is certainly a change in the dynamics of the term structure and suggests that, if the trend consolidates, there is still a risk of the belly (10y) selling off more aggressively, as it outperformed the front end during this move (and would still have more room to catch up with any theoretical, fundamental fair value).

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- We would point out that, as has been the case during recent sell-off episodes in EGBs, periphery spreads managed to weather the storm successfully and we did not see significant widenings for them in this move (in fact, spreads are now tighter than a month ago, even if absolute yields have increased by 20-30bp). This confirms, in our view, that as long as there are trillions of euros in excess liquidity at an extraordinarily low cost (and that excess liquidity is unlikely to be drained in the next few years), an improving macro outlook (which should be taken for granted if the overriding concern is that the ECB could reduce its stimulus faster than previously anticipated) should keep periphery debt relatively attractive.
 - With the **BoJ finally intervening** and announcing a tender to buy 10y JGBs (finding no bids in such an operation, which was part of its yield curve control programme) and given the key events in the US, we expect a much quieter start to the session today, with all eyes on the US employment report. As explained on page 3, we find the recent price action to suggest that the US rates market would be much more sensitive to a weak number today, particularly in wages, than to a strong figure. With CPI and Yellen's Congressional testimony coming next week, and US rates already testing their three-month highs (10y USTs near 2.40%), we see the market as likely to wait for that information before breaking recent ranges. On the other hand, the risk of a correction has increased at these levels and a weak NFP should be a good catalyst for yields to consolidate.
 - On the **sovereign ratings** front, Euro area sovereign ratings scheduled for review today include **Ireland** (A, stable) by Fitch and **the Netherlands** (Aaa, stable) by Moody's. We do not expect any changes in either case.
 - **UK rates:** Yesterday started with a renewed, Bund-led sell-off, which conveniently peaked at the gilt auction deadline (which saw good demand and outperformed its neighbours by 0.3bp over the day). The market then stabilised for a couple of hours, before US data brought some more swings: a soft ADP helped gilts to rally in time for the PAOF deadline, but a very good ISM then drove yields back to their highs of the day. The final net moves were up to 6bp in size, including a further 2-3bp of ASW tightening out to 7y, but neutral spread performances further out. 10s30s flattened a touch (0.5bp), but less than would typically be expected in such a large outright move. Even though US news was very influential, UK rates were moved more: an additional 3bp in 5y, 1.5bp in 10y – see page 3 for more thoughts on this topic.
 - **BoE speakers:** Hawkish MPC member McCafferty, who voted for a rate rise at the latest meeting, was interviewed on LBC radio after most UK markets had closed last night. He only reiterated his known views on monetary policy, but the sterling strip cheapened by another basis point in response, which may set the tone for gilts and GBP swaps this morning.
 - **UK RV:** Yesterday was a particularly bad day for the 23s, whose 7bp sell-off more than reversed their good performance on Wednesday. We have favoured this bond on RV for some time, specifically recommending it vs. the 0H 22s and 2% 25s on [5 June](#). That fly is now back where we entered it after peaking at 2.5bp in our favour, and we continue to advocate it and highlight this as a good entry point.
 - **UK inflation:** Linkers joined the sell-offs elsewhere, which naturally widened breakevens. A boost to oil prices from their inventory data gave the 5-10y BEs an extra kick, although those in the long end underperformed their betas to nominal rates, finally recording some BE concession ahead of the syndication. The 10y BE is nearing 3.0% again, and we would suggest taking profits on our [26 June](#) buy recommendation if it crosses that line again.
- ## FX Strategy
- The USD focus will be on the US employment report. Nonfarm payrolls are expected to increase by 178k in June, compared to 138k in May, which would confirm that the US labour market remains firm. This should be USD supportive, but simply hitting the consensus may not be sufficient to propel the USD higher.
 - Instead, FX attention may be on the average earnings data, forecast at 2.6% YoY compared to 2.5% in May. Faster wage growth would be viewed as positive for US inflation and as strengthening the hand of the FOMC hawks.
 - EUR/USD has held on to levels above 1.1400, following yesterday's USD sell-off and helped by 'hawkish' comments from the ECB's Weidmann. The 30 June high, at 1.1445, should offer strong resistance both today and into next week. Indeed, EUR/USD may reverse some of its recent gains if US wage data come in strong, targeting a move back to 1.1377.
 - The Yen weakened, pulling USD/JPY to its highest level since the 16 May, after the BoJ stated that it would purchase unlimited amounts of 10Y JGBs at a yield of 0.110%. Further, it increased the amount of its 'regular' JGB purchases by JPY50bn.



- The Bank was unable to get all of its bids filled at 0.110%, but the move was interpreted as a sign that, after the recent rise in global yields, the BoJ is determined to keep 10Y yields around zero and therefore prevent Yen appreciation.
- It implies that the USD/JPY uptrend, that begun on 15 May, remains firmly in place, despite Japanese equities weakening overnight. Resistance is currently just about holding at the 16 May high of 113.85 but, if this is breached, 114.37 and then 115 should quickly be targeted.
- The Sterling data focus will be on May industrial production and trade data. The PMI surveys have recently been softer, but still point to a manufacturing sector that is growing, albeit at a slower rate. Hence, the consensus expects industrial and manufacturing production to have grown by 0.4% MoM and 0.5% MoM respectively, in May.
- Hence, on face value, the data should be Sterling supportive, although it is doubtful whether they would be sufficient, by themselves, to pull GBP/USD back above 1.3000. Indeed, given the tendency for UK data to still 'surprise to the downside' in general, the risk may be that the data disappoint. However, GBP/USD's 55-day moving average, currently 1.2875, should offer very strong support.
- At the same time as the US payrolls data, Canada releases its employment report. Unemployment rose to 6.6% in June. The rise came despite an increase in total employment, boosted by a large 70k increase in full-time employment.
- In the past, such strong full-time employment numbers rarely spill over to the next month. Hence, the risks to the report are probably skewed to the downside. A disappointing number would be likely to weigh on the CAD, and boost USD/CAD, particularly if the US jobs/wages data are viewed as USD positive.
- However, with the market still pricing in over an 80% chance that the Bank of Canada will hike the overnight lending rate at its meeting on 12 July, taking it to 0.75% from 0.50%, we would recommend any CAD weakness should be viewed as a better level to buy. Recall that, on 3 July, we recommended selling USD/CAD at 1.3000, targeting 1.2500, with a stop at 1.3250.

Expectations around NFP, especially from a bullish-UK perspective

We find the recent price action to suggest that the rates market would be much more sensitive to a weak number today, particularly in wages, than to a strong figure. We think it would take an extremely strong

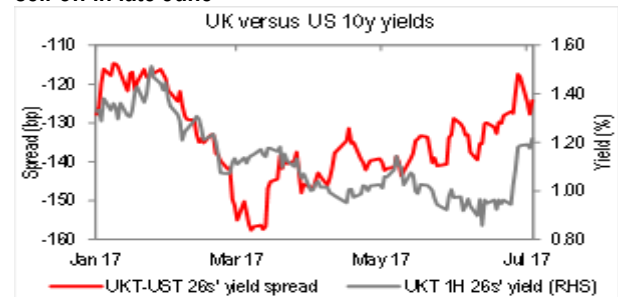
number for the market to think the Fed will be significantly more aggressive than is currently priced in: Dec'17 is almost priced in now, with room for some additional repricing in the FFZ8 future, but the focus now seems to have shifted to how and when the SOMA reduction is finally engaged.

With CPI and Yellen's Congressional testimony coming next week, and market rates already testing their three-month highs (10y USTs near 2.40%), we see the market as likely to wait for that information before breaking recent ranges. On the other hand, the risk of a correction has increased at these levels and a weak NFP should be a good catalyst for yields to consolidate, which we would expect to particularly benefit gilts, given their recent cheapening.

We have a bullish view on UK rates in general, expecting the current very hawkish expectations around the MPC to fade as data continue to disappoint. We identified buying the 10y gilt (1Q 27s) as a good expression in our [Auction Preview](#) and yesterday's [MMD](#), based on supply, RV and our macro/MPC expectations. But yesterday's price action underlined how important developments elsewhere are for the UK market, day-to-day. We believe that UK and US rates can decouple further as their economic outlooks diverge, but our trade remains vulnerable in the short run from events like today's NFP, even though we see the risk/reward of that event as slightly skewed towards a rally.

We find 10y gilts to have a ~82% beta to comparable USTs, which stays fairly stable over different horizons, or if only days with large or bearish moves are considered. Furthermore, the yield differential is around its tightest since February, with plenty of room for divergence even in the absence of a shock (Chart 1)..

Chart 1: UK-US yield spreads were tightening even before the sell-off in late June



Source: Bloomberg, Santander.

So, we would suggest investors concerned about the possibility of a bearish influence from across the Atlantic in coming sessions sell ~80% risk-weighted USTs against our long-10y-gilt position. Alternatively, the gilt could be asset-swapped against USD Libor. Note that its 12bp XCCY ASW (vs. \$3s) represents nearly 9bp of pick-up versus the 2% May'27s Treasury on the same terms.

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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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