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MACRO MARKETS DAILY

Economic data today

- **France June Bank of France Business Sentiment** (exp. 106, last 105). Business sentiment in France has reached its highest level since 2Q11 and now matches the level of activity already anticipated by the PMI reports, especially in the case of the manufacturing sector. In this connection, we expect a significant acceleration in 2Q17E GDP that would come on top of the latest upward revisions to the 1Q17 GDP numbers.
- **For the rest of the week:** The bulk of the data in **the Euro zone** will relate to the June final CPI and the industrial activity and trade balance figures for May. We expect the CPI breakdowns to reflect the negative impact of energy prices, but a gradual upward trend in core inflation. As for industrial activity, we believe the positive indications provided by confidence will translate into an acceleration in activity in 2Q17E, fuelled by exports, and this should also be reflected in the trade balance readings. The most significant release in **the UK** will be the May labour data, on Wednesday, where we anticipate a deceleration in headline (3Mo3M) wage numbers as the anomalously strong February figure drops out of the latest period. There is a small chance that the headline ILO Unemployment rate could drop to 4.5%, but we would expect this to be short-lived and overshadowed, from the market perspective, by any softening of earnings. In **the US**, the focus will be on the inflation numbers for June, which may also have been dragged down by energy prices. We will pay special attention to the control group of June retail sales to monitor the performance of private consumption in 2Q17. The June industrial production numbers could show a pick-up in activity, and capacity utilisation will indicate possible trends in future investments.

Rates Strategy

- **EUR rates:** Last week saw markets remaining very volatile, with jitters over central banks' potential monetary policy moves resurfacing again, along with geopolitical noise, and core bonds seeing substantial repricing (10y Bunds +10bp, 10y UST +7bp in the week). In Europe, the ECB published the account of its 7-8 June monetary policy meeting, showing a "broad agreement" to maintain the current monetary policy stance, while confirming that the inflation outlook was essentially unchanged and the economy was expanding with "more prevalent" upside risks. In the US, the minutes to the June FOMC meeting provided some insight into the possible timing 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 (we believe SOMA reinvestments will begin to be phased out during 4Q17, with these measures only 'eroding' a small fraction of the future hikes currently suggested by the dot chart), with the US labour figures then moving centre stage, and coming in way above expectations (222k vs. the 178k expected) and showing jobs being created in all sectors.
- Global equity markets had lost some ground when they closed last week, especially in Asia and the US (Nikkei -0.5%, S&P500 -0.6%) perhaps caused by heightened geopolitical tensions (North Korea). In the bond market, the Bund traded above 0.55% for the first time since January 2016 and the 10y UST yield was back around 2.38%, the highest in nearly two

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*

months. Periphery risk premia widened as the market focused on uncertainties over the ECB's next move (Spain +6bp to 114bp, Italy +6pb to 176bp, Portugal flat at 256bp) The EUR swap curve steepened, with medium- and long-term rates rising between 5bp and 10bp on the back of higher German yields.

- **This week**, in addition to the key macro data releases, including the Fed's Beige Book, all eyes will be on Yellen's Congressional appearance in both Houses, along with US CPI data. Fed Chair Janet Yellen will be delivering the Fed's semi-annual testimony on the outlook for the US economy and the monetary policy report. With the USD weakening in recent months (and the latest sell-off taking EUR/USD to above the $1.14 mark) there could be room for an even more hawkish bias to Yellen's speeches on Tuesday and Wednesday, and the market will be looking for any hint as to when the Fed's balance sheet reduction measures might get under way and their possible impact on the pace of hikes thereafter. However, we believe it will be crucial to see some bounce back (or at least stabilization) in the core CPI figures (on Friday) to really push the market into fully factoring in the tightening pace the Fed has been announcing so far.
- On the **EGB supply side**, we have **the Netherlands**, **Germany, Italy, Ireland** and **Portugal** selling around €17bn in gross terms (our expectations), although a smaller amount of redemptions (€12.6bn, from the Netherlands) and coupon payments (€4.9bn, mostly also from the Netherlands and Austria) will make net supply less favourable than last week. In the short-dated debt market, **Germany, France, Belgium, Spain, Italy, Greece, the US** and **the UK** will be selling bills this week. Lastly, on **the ratings front**, S&P is scheduled to update its view on Belgium's rating (AA, stable) at the end of the week.
- **UK rates:** The UK outperformed other markets both on Friday and over the week as a whole (10y gilt +5bp), driven by a week of relentlessly disappointing data (all three PMIs, and the hard data for Industrial and Construction Output) and no new views from the BoE speakers. There was an attempt at a sell-off at the start of Friday's session but this was soon arrested by the IP figure, and the rally was cemented after wages let the side down in the US Payrolls release. Gilts outperformed swaps as well as USTs on Friday, reversing some of the tightening earlier in the week, with the shorts and ultras doing best and the middle of the curve tightening a little further. 30y was less fortunate, and ended the day 0.3bp higher in yield, in contrast to the 2.5bp and 1.2bp rallies of 5s and 10s, respectively.
- **UK inflation:** Oil prices' retreat, weak economic data and the imminent syndication put linkers under pressure on Friday. The weakening of sterling was largely ignored, but may start to boost front-end BEs if it goes much further. The 10y real yield did not move, but that still means a 1.5bp tightening of its breakeven, similar to those seen across the curve. The weakest spot was 30y, as in nominals, suggesting accounts may be selling there rather than in ultras to make space for the sale, but plenty of concession has now been seen from many angles. Despite this (small) move, 30s50s RY is extremely steep by its own standards, even though still inverted: the IL62s yield is just 0.6bp below the IL44s' and has hardly ever been upward-sloping, at least not since January 2015. The equivalent nominal 30s50s remains well inverted (44s/60 -16.5bp), and we expect ultra-long linkers and breakevens to perform well over the summer.
- **This week in the UK:** Labour –specifically, wages– will naturally be of great interest, but BoE Deputy Governor Broadbent's speech at noon tomorrow has the potential to be even more significant. He is the last member of June's MPC to comment since the 5-3 vote, and Committee members have proven power to impact the markets, in either direction. We expect him to stick fairly closely to the Governor's line, and to join his colleagues in emphasising the BoE's data dependence; given the state of recent data, that should be considered as a fairly dovish sentiment. We will likely have the 40y linker syndication out of the way by then, clearing the way for the long end of the gilt curve to start enjoying the negative net supply period that lies ahead
- **UK supply:** The DMO intends to reopen a 40y gilt linker (IL 0.125% Nov'56s) by syndication this week, most likely tomorrow, for at least £2bn nominal (£4bn cash proceeds). The remaining two gilt linker auctions this fiscal year are likely to launch and build a new 30y benchmark, which suggests very light ultra-long linker issuance for the rest of the fiscal year, perhaps just a couple of auctions. We see this as a strategic buying opportunity in long real yields, which ended last week within a whisker of their highest for almost a year. In the other direction, £3.21bn of nominal and £0.17bn of linker coupons will go ex-div on Friday.

FX Strategy

- Overall, the USD made a stable start to the week in overnight trading, with the **USD index** unmoved around the 96.00 level. However, **USD/JPY** has strengthened above 114 amid Nikkei gains and BoJ

Governor Kuroda's warning that the Bank will continue to adjust policy as needed.

- **EUR/USD** is back to hugging the 1.14 level, with the 30 June high at 1.1445 likely to remain a tough level to break above over the coming week. Similarly, 0.8880 in EUR/GBP should continue to offer resistance, and with GBP/USD set to remain in a 1.2875-1.3000 range.
- The IMM non-commercial position data for the week ended 4 July showed the net short **GBP/USD** having been reduced, but the net long EUR/USD position has recovered over the last couple of weeks, suggesting that the change may be more due to a more negative stance on the USD than a positive GBP view.
- The **EUR/USD** position is now back at 77k contracts, not far off the recent high set in mid-June, which was the most since late Q2-11, reflecting that speculators remain positive on the EUR.
- Elsewhere, the **NZD/USD** net long position has also increased and is not far off its record high achieved in April 2013. NZD/USD started an uptrend on 12 May, bit this has recently shown signs of petering out, with the pair hovering around 0.7300, with strong resistance seen at 0.7345.
- In addition, ahead of the Bank of Canada rate announcement this Wednesday, the net short CAD position against the USD has been cut for a sixth consecutive week. Speculators are still notably net short the CAD, but the position is now at its lowest since mid-April. **The interest rate market is now pricing in a 93% chance that the BoC will hike rates at the meeting**. USD/CAD is currently around 1.2880, and we expect the pair to drop to 1.2500 by the end of Q3-17.

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Antonio Villarroya, Luca Jellinek, José María Fernández, Edgar da Silva, Antonio Espasa, Laura Velasco, Beatriz Tejero, Stuart Bennett, Michael Flisher, Stuart Green, Adam Dent

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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
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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

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