

MACRO MARKETS DAILY

Economic data today

- **Italy May Industrial Production** (exp. 0.5% MoM and 2.0% YoY, last - 0.4% MoM and 1.0% YoY). The increased activity and demand in other European countries should help to sustain the sector more evidently.
- **US May Final Wholesale Inventories** (exp. 0.3% MoM, last 0.3% MoM). The May ISM Manufacturing showed a slowdown in production and a slight acceleration in the generation of inventories and new orders. This could result in stronger-than-expected wholesale inventories and sales numbers for the month. **June NFIB Small Business Optimism** (exp. 104.4, last 104.5).
- **Central bank speakers:** The ECB's Coeure, the Fed's Brainard, and the BoE's Broadbent (the last MPC member yet to speak since the June meeting).

Rates Strategy

- **EUR rates** corrected lower, yesterday, following two straight weeks of sharp increases in EGB yields. **The 10y Bund was about 3bp lower, outperforming by 1-1½bp against the Euribor curve.** We still like 5y OBL in ASW, as a near-term 'bullish' trade. Slopes remain directional, so a little bit flatter yesterday. It is quite striking that, as we were writing our I&E monthly in the last week of June, the clear risk in rates markets seemed to be that of excessive complacency on the part of investors regarding rates risk, and that now, with 10y Euribor rates 26bp higher, a bearish narrative pervades commentary. The debate between Phillips curve adherents (who expect the current strength in output and employment to eventually generate faster inflation) and sceptics (that point to stubbornly low wage and core inflation levels) has not been satisfactorily resolved, however. The latter view is underscored by the moderate rise in break-evens, relative to nominal rates and, indirectly, by the sharp underperformance of 5s and 10s vs. the short end and 30s. **Near term, we think that further correction in rates makes more sense than rises.** Longer term, we find rates can push higher, but only very gradually, over several quarters.
- **Another correction was in the 10y SPGB-Bund spread.** After protracted tightening, periphery spreads widened last week, reacting to the same concerns about premature tightening, which are probably overdone. At levels above 110 bp, the SPGB-Bund 10y it is still comparatively attractive, in our view.
- The comparatively more interesting appointments, today, are the NFIB in the US (12:00 CET) and Coeure's speech (14:00 CET). The latter should be of particular interest as he has expressed a nuanced take on policy flexibility and timing, since May.
- **Debt supply:** In the Euro area today, **the Netherlands**, for the second time this year, reopens its 30y DSL (2.75% Jan'47) for up to €1.25bn. In the short-dated debt market, **Spain** will be selling 6m and 12m bills for up to €3.5bn, and **Belgium** 3m and 12m bills for up to €2.4bn. In the US, **the US Treasury** will be offering, first, \$40bn of 4-week bills and, later on, \$24bn of a new 3y note (1.5% Jul'20).

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- **UK rates** continued their recent outperformance in yesterday's (small) global rally. Short- and long-dated gilts outperformed swaps, while 5-10y spreads were little changed. The strength of long gilts was even more notable versus USTs (10s30s UK -1bp, US +1bp, Bunds unchanged) and surprising on the day before a likely 40y linker syndication: the 4Q 55s were the best-performing gilt! Flattening was also seen in the very front end, as last week's weak data continue to grind away at hike expectations: the first hike is still priced for as soon as May 2018, but subsequent hikes are fading and our receive 1y1y vs. 1y and 2y1y fly recommendation ([22 June](#)) is approaching its target.
 - **UK inflation:** Linkers lagged the nominal rally, squeezing breakevens 3bp across the curve (2bp, beta-adjusted for the nominal rally). There was little in the way of moves in the currency or oil prices to drive the front end. Long real yields around -1.40% still look cheap, but may need the syndication to be out of the way and digested before they can start recovering properly.
 - **UK supply:** The DMO intends to reopen a 40y gilt linker (IL 0.125% Nov'56s) by syndication this week, most likely today, for at least £2bn nominal (£4bn cash proceeds). The bond has shown little movement on RV versus its neighbours, but we see this as a sign of illiquidity rather than as a genuinely firm valuation. The IL58s themselves have cheapened sharply, so even the reported 2bp spread over them may represent good-enough value. 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, outright and also on the unusually steep 30s40s real curve.
 - **Trade idea: Buy the UKTI 56s versus the UKTI 46s** (30s40s real yield flattener). Enter at 0.3bp, targeting -1.5bp, with a stop at 1bp. A 30s40s gilt breakeven box (or 30y BE vs. 50y RPI swap) also appeals.
 - **GBP/USD** finally broke below support at its 55-day moving average of 1.2876 on Monday. It did, temporarily, reverse some of its losses in Asian trading, but we believe the move opens up the prospect of the pair testing the 14 June high at 1.2818, and then 1.2800.
 - The Pound remained subdued, despite BRC retail sales data showing that June spending was stronger than expected, at 1.2% YoY, compared to -0.4% YoY in May. Whether Sterling weakens further may depend on what MPC member Broadbent says in a speech at noon today. We suspect that he may err on the dovish side, in line with Governor Carney, but any repetition of other MPC members' comments, suggesting that UK interest rates may rise sooner than many had expected, could quickly bring the 1.3000 level back into play.
 - **USD/JPY** has broken clear of the 114 level and moved above its 11 May high at 114.37, continuing an uptrend that started on 16 June. Higher US 10Y yields and firmer Asian equity markets have reduced demand for the Yen. EUR/JPY has held above 130, and has now completely reversed the losses that it recorded between early February and late June 2016.
 - **EUR/USD** is holding below 1.1400. With little in the way of Eurozone economic data to provide fresh direction, we suspect that the pair will hold within a narrow range, capped on the upside by its 30 June high at 1.1445 and, on the downside, supported at 1.1369.
 - The NZD was the major underperformer in Asian trading. **NZD/USD** is down around 1.1% from yesterday's high as a retail spending measure disappointed. Recall that the IMM non-commercial position data showed that speculators are very long NZD/USD, suggesting that any disappointing data can provide a catalyst to pare back these positions. NZD/USD hit a low at 0.7225, with support seen at 0.7200.
- Update on the ECB's EAPP: Overall weekly purchases the highest since the beginning of April**

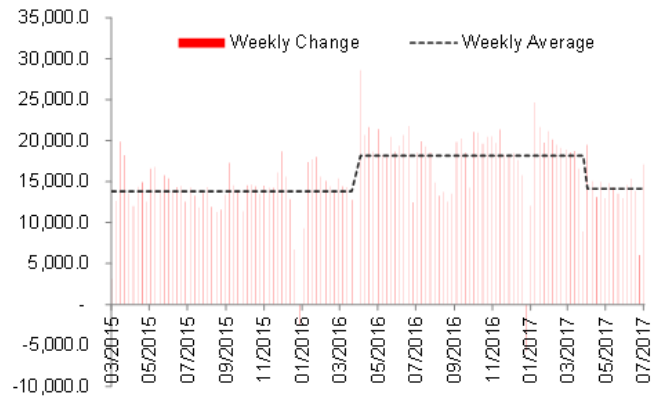
FX Strategy

- The USD is slightly stronger in general, helped by a pick-up in US yields, although a **USD index** level of 96.20 looks like it may offer resistance in the short term. The US 10Y yield has been a key driver of USD sentiment and demand. Note that the correlation between the USD index and the US 10Y yield over the last year is 0.8. However, we estimate that, based on that yield alone, the USD index is too low and should be closer to 98.50.
- Yesterday, the ECB updated the details of its [Expanded Asset Purchase Programme \(EAPP\) holdings](#), which included the purchases settled as at 7 July. According to the overall figures, asset purchases have increased by €17bn last week (to €1,970bn), exceeding both the €6.1bn reported last week and the €14.1bn weekly purchasing average since 1 April, reflecting a faster pace than in preceding weeks. The ECB could be frontloading its buying in view of the usual thin liquidity over the summer break. Also, this weekly average of €14.1bn is higher than June's €12.5bn, but falls short of



the €15.7bn overall weekly average since March 2015 (Chart 1).

Chart 1: The ECB's EAPP portfolio: Weekly change vs. weekly average (€bn)

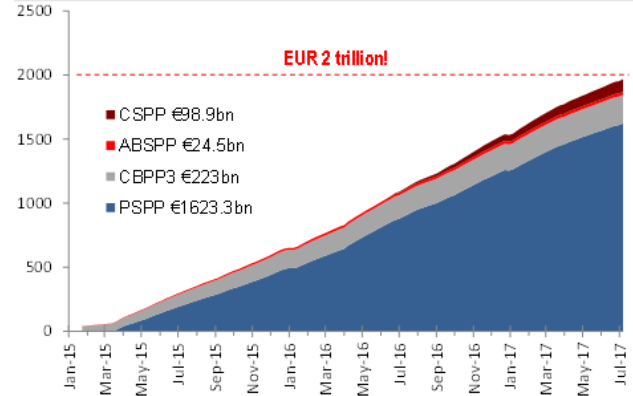


Source: ECB, Bloomberg

As the ECB's EAPP approaches the €2trn mark, **PSPP** holdings now stand at €1.62trn, an increase of €14bn on the previous week (last week's rise was €4.4bn), and represent 82.1% of last week's ECB purchases. The **CSPP** has added €2.3bn to the number reported

last week, now near the €100bn mark (€98.9bn) and accounting for 13.4% of last week's total. **CBPP3** holdings have reached €223bn, €416mn more than in the previous week (versus the €207mn decrease reported last week), making up 2.4% of last week's asset purchases. Lastly, holdings via the **ABSPP** now stand at €24.5bn, €349mn more than in the previous week (vs. the €508mn increase posted previously), making up the remaining 2.1% of purchases.

Chart 2: The ECB's EAPP portfolio: €1,970bn



Source: ECB, Bloomberg, Santander

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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.
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