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MACRO MARKETS DAILY

Economic data today

- **Spain May House Transactions** (last -8.6% YoY). The strong improvement in the labour market, together with the containment of prices in the housing sector, should help house transactions recover in the coming quarters.
- **Euro zone May Industrial Production** (exp. 1.0% MoM and 3.5% YoY, last 0.5% MoM and 1.4% YoY). The various country confidence reports and output readings already released have been signalling a strong rebound in manufacturing activity in the area, recently supported by the surge in exports.
- **UK May Unemployment Rate** (fcst. 4.6%, last 4.6%), **Average Weekly Earnings** (inc-bonus fcst. 1.7% 3MoY, last 2.1% 3MoY), **Employment Change** (fcst. 134k 3Mo3M, last 109k 3Mo3M). There is a chance that the headline ILO Unemployment rate could dip to 4.5%, as the higher single-month figure for February drops out of the calculation period, but we would only expect this to be temporary. The deceleration we forecast in headline wages conversely reflects the departure of a strong single month data point for February, but this would fit the prevailing trend of weak pay growth despite the labour market's strength in headcount terms. We will also be watching for any revision to the April pay data on the back of the National Living Wage. We expect there to have been a small increase in employment numbers in May, adding to the influence of a strong figure for March in the headline job creation rate
- **The Fed's Yellen to appear before the US House Panel.**
- **The Fed releases its Beige Book.**
- **Central bank speakers:** The ECB's Visco and the Fed's George.

Rates Strategy

- **EUR rates:** After Monday's rally, EGB core yields dropped across the board yesterday, in a session marked by poor volume ahead of one of the week's most important events, Yellen's testimony to Congress, boosting investors' call for caution. The German curve (2s30s) steepened slightly (+1.2bp) during the day, with the 30y German Bund yield hitting the highs of the last 17 months in the session (1.3736%), while the 10y Bund yield rose around 1bp to close to 0.55%, ahead of today's 10y German auction.
- Periphery govies suffered in yesterday's session too. In the short end, Spain and Portugal were the exceptions, seeing their 2y yields down around 1bp on average to -0.248% and -0.023%, respectively, while the Italian 2y yield rose more than 1bp to -0.147%. In the 10y sector, the SPGB yield was up around 2bp to a little below the 1.68% level, while the 10y Portuguese (+2.3bp to 3.093%) and Italian (+4.6bp to 2.31%) bond yields rose more, with the threat of the ECB's QE coming to an end continuing to affect periphery assets.
- Today, the market will mainly be focusing on Fed Chair Janet Yellen, who testifies before the House Financial Services Committee in the US House of Representatives, addressing politicians on monetary policy and the state of the US economy. Investors will be looking for any hint in her prepared

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testimony as to when the Fed's balance sheet reduction measures might get under way and their possible impact on the pace of hikes thereafter. And, later in the afternoon, the Fed will also be publishing its Beige Book with information on the current economic conditions in the US.

- Lastly, on the **Eurozone supply front**, **Germany** is scheduled to launch a new 10-year DBR (0.5% Aug'27) today, aiming to place €5bn, while **Portugal** will be reopening its 10y (4.125% Apr'27) and 30y (4.1% Feb'45) PGBs for up to €1bn. In bills, **Italy** will be selling €6.75bn of 364d bills and **Greece** €0.6bn of 91d bills. Across the Atlantic and after Yellen's testimony, **the US Treasury** is set to place $20bn of its 10y Notes (launched in May).
- **UK rates**: Yesterday was an extremely choppy and indecisive session. BoE Deputy Governor Broadbent's speech was the most anticipated domestic event of the day, and the focus increased further after his speech was postponed by 90 minutes, seemingly to avoid clashing with the linker syndication pricing. But this proved to be a non-event for markets, involving a theoretical discussion around trade, productivity and Brexit, but no comments on monetary policy. Very short sterling rates had sold off by several basis points earlier, which more than reversed in the afternoon. Longer tenors also started the day weak and rallied through the session, with swaps ending ~1bp richer across the curve (as in USD) but gilts -1.5bp cheaper (like Bunds). 5-6y gilts were the weakest point in the UK, perhaps from an increased focus on next week's new 5y issue, after confirmation of its details: £2.75bn of 0.75% Jul'23s. Ultra-long gilts were also on the weak side, but performed well given the syndication (30s50s +0.4bp).
- **UK inflation:** Linkers were under pressure all day, ultras in particular, thanks to the syndication. This attracted a record order book (£14.8bn nominal) and an unusually high (11%) allocation to overseas investors, but these stats were not enough to set a positive tone in the market. Real yields rose 2-3bp, led by the longest tenors, giving breakevens a clear flattening profile (IL27s' -1bp, IL46s -2bp, IL62 -2.5bp). Sterling's depreciation and oil prices' rise throughout the afternoon were seemingly ignored, which could pave the way for a front end-led bounce in breakevens once the syndication is absorbed, if those moves can persist.
- We also see the risks around today's UK labour release as likely to be skewed to the upside for inflation (and short rates). In contrast to last Friday in the US, when the market seized on disappointing wages as a challenge to hawkish expectations, poor UK pay growth is already widely anticipated and the centrepiece of the dovish arguments within the MPC. There is still plenty of room for UK short rates to continue (slowly) declining if our economic forecasts are correct, but any 'good news' relative to low expectations around pay could rattle markets and put the hawks back in focus, at least temporarily.

FX Strategy

- The USD has held on to Tuesday's losses, which were sparked by comments from the Fed's Brainard that were perceived as dovish. She indicated that plans to shrink the Fed's balance sheet should go ahead, but that inflation pressures should be reassessed before undertaking further rate hikes. The USD's Fed focus will now be on Yellen's comments later today.
- Consequently, the **USD index** tested support at the 30 June low of 95.470. However, EUR/USD has finally broken above its 30 June high at 1.1445, reaching its highest level since May 2016 and moving toward a test of 1.1500 levels.
- **EUR/USD** gains are being driven by dollar factors but, if confirmed, the forecast rise in Eurozone IP for May of 1% MoM (published later today) should be a reminder that Eurozone fundamentals are also EUR positive. The 1% rise in output would be the biggest monthly gain since November 2016.
- The combination of a soft USD and weaker Japanese equities has pulled **USD/JPY** lower, to back below 114. That said, the uptrend in the pair that began in mid-June continues to hold, despite its recent decline.
- The **Sterling** focus will be on UK employment data. Overall, UK economic data have tended to surprise on the downside since mid-May, although the employment figures have generally been robust and GBP positive. But the spotlight will be on wages. Slower wage growth would be viewed as reducing the pressure on CPI, thus allowing the MPC to keep rates unchanged, and therefore could be a Sterling negative factor.
- The **GBP/USD** sell-off during July has continued. Despite the weak USD, Cable's 30 June high at 1.3030 looks unlikely to be revisited in the short term. Instead, the 55-day moving average, currently at 1.2876, which had been offering the pair support for much of July, could now be viewed as a resistance level, and failure to move back above it over the coming days may prompt further weakness and a move back to the 28 June low of 1.2779.
- Comment's from the BoE's Broadbent, in a newspaper interview published this morning, indicating that he is not ready to support a rate hike yet should also allow GBP/USD to test these lower levels.

- The BoC is expected to hike rates today, taking the overnight lending rate to 0.75% from 0.50%. But, even if it does not, the Bank's tone is likely to be hawkish and 'confirm' that a rate hike is probable before the end of the year.
- The market had been caught short with regard to the **CAD**. A softer oil price had encouraged speculators to bet against the commodity-related currency. Indeed, the IMM data showed that the net short CAD position versus the USD hit an all-time high at the end of May.
- This position has been unwound recently, but speculators remain significantly net short the CAD, with ample scope for the position to be unwound further (boosting the CAD) if the BoC does hike or adopt a more hawkish stance.
- Plus, the CAD's correlation with the oil price should start to work more in its favour. The WTI oil price is around USD45/bbl in June, from USD52/bbl in late May. However, the consensus oil price forecast, published by Bloomberg, still predicts that the WTI will end the year at USD55/bbl. Using data covering the last two years, we estimate that a 'fairer' value for **USD/CAD**, with WTI at USD55/bbl, would be 1.26, rather than the current 1.3000.

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