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MACRO MARKETS DAILY

Economic data today

- **Euro zone June final CPI** (exp. 1.3% YoY, prel. 1.3% YoY, last 1.4% YoY). The preliminary CPI breakdown showed a sharp moderation in the contribution of the energy component and of food prices, but a rise in core inflation to 1.1% YoY from 0.9% YoY previously, mainly supported by services prices. For the coming months, we see a downward risk for overall inflation given the trend in energy prices in euros but, at the same time, the encouraging numbers for activity and demand in the area clearly support our scenario of aggregate core inflation gradually rising towards 1.4% YoY at the end of the year. That said, the volatility in the monthly data could be high.
- **This week:** There are few major items on this week's agenda. The ECB meeting on Thursday is probably the most important, although we do not expect any significant announcements this time. On the economic data front, we will have trade balance figures in Spain, which should highlight the health of the external sector once again. In the Euro zone, consumer confidence and the ZEW survey are the economic references that could attract some attention in the market.
- The main event in **the UK** will be tomorrow's inflation release, where we expect a slight deceleration in the annual pace, with an increasing drag from fuel prices. UK June retail sales, expected to bounce after a very weak May, will be secondary but still important. Today's second round of Brexit negotiations will also be in focus, including whether the warm tone of the first press conference (on 19 June) can be maintained, or if discussions already start to become strained.
- In **the US**, housing starts and building permits are likely to have improved last month, after some disappointment in the previous ones. Leading indicators should have strengthened again in June, while the Philadelphia Fed index should decline slightly after very good numbers in earlier months. In any case, this indicator already anticipates stronger economic growth rates in the coming months.

Rates Strategy

- **EUR rates:** Last week was marked by the dovish message from various Fed representatives (mainly Brainard and Yellen), with the focus on the US CPI figures for June (which finally came in below expectations at both the headline and core inflation levels). In her semi-annual prepared testimony (perhaps her last) to the both Houses of the US Congress (House Financial Services Committee and the Senate Banking Committee), Janet Yellen reiterated that the US economy is strong enough to digest further rises in interest rates, while "monitoring inflation developments closely in the months ahead". Also, Yellen confirmed that the Fed will begin paring back the balance sheet growth accumulated during the crisis "this year", mentioning that, once this process is over, its size would be uncertain because, among other things, the banking system's future demand for reserves is unknown. And, after the release of the US CPI figures, the risk still remains biased to higher rates in the US in the medium term. It was a good week for global equity markets on the back of these dovish words from Fed members, the ongoing recovery in oil prices and 2Q earning

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*

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seasons kicking off with better-than-expected corporate results (EuroStoxx +1.6%, Ibex +1.6%, S&P +1.1%, Nikkei +1%). In the bond market, German 10y Bunds yields rose slightly, ending last week below the 0.6% mark, while US Treasuries moved in the other direction (10y UST -7bp to 2.31%), while Eurozone periphery risk premia tightened in general terms (e.g., Spain -10bp to 106bp vs. 10y Bunds).

- **This week**, as the summer break approaches, the agenda is filled with key events such as the ECB meeting on Thursday, where we do not expect a significant announcement despite the recent noise since last month's Sintra ECB event. Also, the Bank of Japan holds its monetary policy meeting, with no changes in rates expected either. On the economic data front, markets will be focusing on the Chinese 2Q17 GDP, final June CPI data in the Eurozone and the German ZEW survey for July, and US leading indicators also for June, among others.

- In **supply terms**, **Germany, Spain** and **France** are set to sell bonds this week for an estimated total surpassing the €15bn mark, with €6bn in redemptions and €0.8bn in coupon payments, mostly from Greece, to go some way towards offsetting this supply. Across the Atlantic, the **US Treasury** aims to sell $13bn of a new 10-year linker (0.5% Jul'27) on Thursday with no scheduled bond redemptions or coupon payments this week.

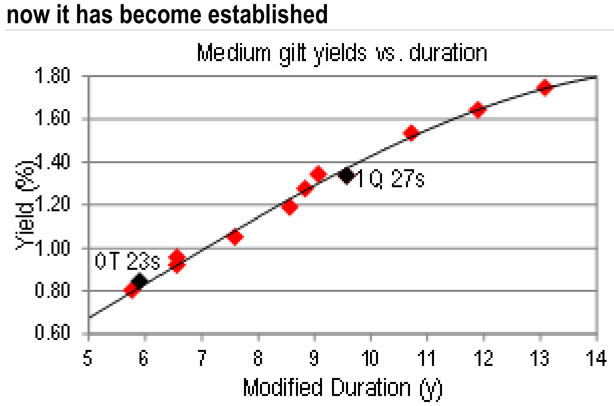
- Finally, Euro area **sovereign ratings** scheduled for review on Friday, 21 July, include Fitch on **Spain** (there is a decent chance of the outlook being improved from 'stable' to 'positive', following S&P's lead last March) and S&P on **Greece**.

- **UK rates** sold off (slightly) on Friday, with no overspill from the post-CPI rally in the US and completing a week of cross-market underperformance. We believe catch-up will be on the cards for this week, especially if UK CPI decelerates slightly tomorrow, as we (but not consensus) forecast. We think pre-hedging of sterling corporate issues for this week may have contributed. Gilts generally widened a touch vs. swaps on Friday, as £3.2bn of long-date-biased coupons went ex-div; the light or negative supply environment should remain supportive for gilt spreads.

- **UK inflation:** Linkers continued to suffer on Friday, with a strong day for sterling (Cable ended the session above 1.30) overshadowing the week-long rally in oil (which still left Brent below $49/bbl). Real yields rose by up to 5bp and breakevens fell by 3-4bp on the day, making for a 10bp sell-off in the 10y linker over two sessions. We expect nominal rates to take some comfort from a consensus or lower inflation print tomorrow, but see linkers as now well braced for any such downside surprises and with room to perform again on breakeven – barring further sterling appreciation from other drivers.

- **UK supply – new 5y on Wednesday:** The DMO will auction £2.75bn nominal of a new 0.75% July 2023 gilt on Wednesday, with a DV01 of around £1.6mn. Grey market trading in this issue has been quite active, and it finished last week with a less than 4bp yield spread over the 2Q Sep'23s. That bond has a longer maturity, but slightly shorter duration, but we see it as one of the cheapest gilts on the curve. A duration-based fitted curve suggests the new bond is about 1bp cheap to 'fair value' (Chart 1), but adjusting for the premium on higher-coupon gilts in this sector trims this to less than ½bp. This looks very tight compared to the 2bp new-issue discounts seen in historical 5y gilts, let alone the 4bp that applied to the 0H 22s last year, until their second tap, so we would wait for a cheaper valuation at, or after, the auction. It would take at least a 5bp spread over the old 23s –which we see as one of the cheapest gilts of all on RV– for us to favour the new issue.

Chart 1: The new 5y gilt looks only very slightly cheap for its duration, whereas we see the new 10y as slightly rich now it has become established



Source: Bloomberg, Santander.

- **Close trade idea – buy UKT 1Q 27s vs. 4Q 27s:** This switch –[recommended] on 3 April, ahead of the new 10y's second tap– has been performing well since the 27s' latest (fourth) sale on 6 July. They outperformed again in Friday's sell-off and smashed through our target. They are now looking rich on regression and fitted curves (Chart 1), so we close the RV recommendation here. Note that we also currently [recommend] long positions in 10y gilts, outright or [hedged] against US rate moves: we still hold that more macro-based view, although the 4Q 27s, rather than the original 1Q 27s, would now be our bond of choice for new entrants.

FX Strategy

- The **USD** has held on to most of Friday's losses, after softer-than-expected June US CPI and retail sales data dragged the currency lower at the end of last week. However, the market's appetite to sell the dollar even further at the start of this week may have diminished, with the USD at least off of its overnight lows in Asian trading, and the **USD index** back around 95.20, compared to around 95.65 just before the data releases.
- The weaker USD has naturally boosted **EUR/USD**, with that pair clearly holding on to the uptrend that began in mid-April and with a test of the 12 July high at 1.1489 looking possible over the coming week. Further, the IMM non-commercial position data for the week ended 11 July showed that the net long EUR/USD position is now at its highest since early May 2011.
- However, final Eurozone CPI data for June are expected to confirm that headline inflation slipped to 1.3% YoY from 1.4%. 'Soft' European CPI figures could limit further EUR gains if they remind the market that a slower US CPI may eventually spill over to the other developed market economies.
- As such, there may be scope for **EUR/GBP** to add to its losses at the end of the week. Sterling, in our opinion, still seems oversold, which should imply a reluctance to sell the Pound aggressively, without 'new' signs of economic weakness or political uncertainty.
- **GBP/USD** has risen above 1.3100 for the first time since September and, therefore, should be able to hold above its new support at 1.3000, although the resumption of Brexit negotiations between the UK and the EU will need to be watched for any Sterling-negative signals. That aside, EUR/GBP may be able to test support at its 55-day moving average of 0.86950.

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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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