

# MACRO MARKETS DAILY

## Economic data today

- **Germany July ZEW Survey Expectations** (exp. 18.0, last 18.6). The index could improve in the next few months, in line with the acceleration of the German economy seen since the beginning of the year. The performance of other leading indicators, like the IFO, is also consistent with further improvements in the ZEW.
- **UK June CPI** (fcst. 2.8% YoY, last 2.9% YoY), **Core CPI** (fcst. 2.5% YoY, last 2.6% YoY), **RPI** (fcst. 3.6% YoY, last 3.7% YoY). Please see page 2 for our preview of the key factors behind today's inflation data.
- **ECB Bank Lending Survey**. Loans to households increased to a rate of 2.6% YoY in May from 2.4% YoY in April, while loans to non-financial corporations remained at 2.4% YoY in the month. We expect the financial sector to progressively increase its contribution to the recovery of the economy in the area.
- **US June Import Prices** (exp. -0.2% MoM and 1.3% YoY, last -0.3% MoM and 2.1% YoY). We expect evident downward pressures from the trend in energy prices during the month. **July NAHB Housing Market Index** (exp. 67, last 67).
- **Central bank speakers**: BoE Governor Carney will speak at the launch of the new, polymer £10 note, but is highly unlikely to mention monetary or other policy matters.

## Rates Strategy

- **EUR rates**: Yesterday's was generally a good (and very quiet) session for the European bond market, as investors began to focus on the week's key event (the ECB meeting) after the confirmation of no changes in prices during June in the Eurozone. Core govie yields dropped in all tenors yesterday, with that on the 30y Bund edging back down to below the 1.3% level during the day (and closing at around 1.31%), while 5y German yields managed a similarly good performance, ending more than 1bp down, at around -0.12% at the end of the day. EUR swap rates followed suit, with yields falling all along the curve (10y EUR IRS -1bp to 0.95%). Periphery paper outperformed core and semi-core bonds from the belly out. In the 10y sector, Italy performed particularly well, with the 10y BTP succeeding in tightening in to below the 2.25% level (-5.4bp to 2.22%), while the Spanish 10y yield dropped below the 1.60% mark for the first time since 5 July (-5bp to 1.58%). The 10y Spanish spread vs. Germany tightened by around 4bp, to close below the 100bp mark (99.7bp) for the first time since October 2016.
- **ECB buying**: Please see below for the latest details on the EAPP program.
- **Debt supply**: Today, in the short-dated paper market, Spain will be selling 84d and 259d bills for up to €3.5bn, and the ESM is selling up to €1.5bn of 189d bills. Across the Atlantic, the US Treasury will test the short-dated market again, selling \$45bn of 4-week bills and another \$20bn of 52-week bills.

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- **UK rates** outperformed other markets yesterday, making up some of the ground they lost last week and returning gilts to roughly where they were a week ago (caught in between the 6bp sell-off in Bunds and the rally in USTs over the same period). 10y gilts led the way, rallying 4bp, including 1.5bp of spread widening. The long end lagged, steepening 10s30s by 1.5bp and tightening ultra-long spreads by as much as 10y widened. 30s50s is still near its most inverted (45s/68s through -20bp), so we think ultras are overdue some underperformance. The sterling strip joined in, but the whites are proving stickier, leaving the first hike still priced for May/June 2018. Cabinet infighting over the weekend was a likely cause of the rally, which also served to highlight the challenges and divisions around the approach to Brexit: the idea of a rate hike against such a volatile backdrop is looking increasingly unwise to us, regardless of the fine details of today's inflation print.
- **UK inflation** remained firmly out of fashion ahead of today's print, increasing the skew of risks in the market around stronger numbers. Real yield moves were all small but a mixed bag, but the breakeven moves were more consistent: a 3.5bp narrowing in the 5-20y region and a slightly milder 2-2.5bp further out. The MPC's hawkish minority seem to have done a very effective job of taking all the heat out of market inflation expectations, but we see 5-10y BEs as too pessimistic and expect some recovery towards 3% as and when the hawks pull back in the face of the deteriorating macro data we expect.

## FX Strategy

- The USD weakened across the board as the current proposals to reform the US healthcare system have been ditched by the US Republicans, amid an apparent lack of support. The decision is seen as raising doubts about the US administration's ability to make other planned changes, including to the tax system. As a result, the USD index dropped below 95.00 for the first time since September 2016.
- The weak USD pulled EUR/USD above 1.15, the highest it has been since May 2016. The 3 May 2016 high, at 1.1616, should now offer a target/resistance. The question now, in our view, is whether such a strong EUR –recall that the pair has been on an uptrend since mid-April– will force the ECB to attempt to 'talk' the currency lower. And, if it does, will the Central Bank be successful?
- Either way, we assume that the ECB will not feel comfortable with the speed of the EUR's appreciation since mid-June, particularly given the

recent downward CPI revisions that were made to the ECB staff forecasts.

- Hence, the buoyant EUR may at least provide an excuse for Draghi not to err too much on the hawkish side, and boost the currency further, at Thursday's press conference following the ECB policy announcement.
- Sterling had underperformed the EUR, as the USD weakened, implying a stronger EUR/GBP. But, a chunk of these gains have reversed, with EUR/GBP testing support around 0.88. The GBP focus today is on the UK's CPI, with the market expecting the June print to be unchanged, at 2.9% YoY.
- We expect a slightly lower outcome, which might be enough to pull the Pound lower but, with the market eyeing a soft USD, GBP/USD could still hold around 1.31, with a softer Pound playing out primarily against the EUR.
- As Japan returned from Monday's holiday, the Nikkei declined by over 0.5%. The combination of equity weakness and USD softness would, in our opinion, normally have provided a big boost to the Yen. The JPY has strengthened, but only in line with most of its G10 peers.
- It may be that losses in USD/JPY are being constrained as it approaches some very strong support at around 111.80, where its 50-, 100- and 200-day moving averages currently reside.
- The biggest winner overnight was the AUD, as it gained over 1% against a softer USD. Indeed, AUD/USD reached 0.7908, the highest since May 2015, after the Minutes to the recent RBA meeting struck a dovish tone. The Bank expressed confidence in the labour market and indicated that it implied less downside risks to wages.
- However, it also suggested that the RBA is not close to following the Fed and BoC in hiking rates. As such, some of the 'excessive' AUD gains could reverse over the next day or so, with, perhaps, the pair slipping back toward the low 0.78 levels.

## UK Economics: June inflation figure expected to calm a still unconventional policy debate

An absence of scheduled Bank of England speeches this week should help to calm a degree of the speculation around the UK monetary policy outlook –at least temporarily– with the focus likely to fall instead upon this morning's release of the June consumer price data. Although the debate across the Monetary Policy Committee (MPC) has recently appeared somewhat frantic to us –not least Ian McCafferty's suggestion last week that the Bank should consider an early unwind of



its gilt holdings— we still feel that the policy decision rests with the framework of determining the degree of inflation overshoot that should be tolerated within an uncertain growth environment.

This morning's data —which we expect to show the annual rate of UK CPI inflation easing to 2.8% in June, below both the May figure and the consensus expectation of 2.9%— should, therefore, fall at the heart of the policy discussion. But, for the most part, we believe that the differences across the MPC relate more to the outlook for growth than the near-term inflation figures and, in particular, whether the uncertainty created by the Article 50 process still requires an exceptional bias within the policy decision, with growth rather than inflation remaining the dominant factor for that decision.

Although last week's releases saw the headline unemployment rate falling to a fresh 40-year low for the UK—again questioning the degree of remaining slack within the economy— we continue to believe that an exceptional focus upon growth, rather than inflation, is still warranted, given our concerns around the outlook for GDP growth in 2017 and beyond.

For example, following the release of the May data, the current level of industrial production stands 0.5% below the Q1-17 average, and a more worrying 1.8% below the December 2016 figure, with the comparable figures for construction output standing at -2.2% and -2.5%, respectively. Should output within the industrial and construction sectors remain unchanged in June, we estimate that these areas of the UK economy would directly reduce Q2 GDP growth by a combined 0.18%pts, highlighting the continued reliance upon the services sector and, in turn, the vulnerability of the UK economy (over both the short and medium term) to any further slowing of consumer expenditure.

Overall, we remain comfortable with our forecast for a 0.3% rise in the UK's Q2-17 GDP —the first estimate of which is released on 26 July— following on from the sub-par 0.2% rise reported for Q1-17. Moreover, with the political risks around the Brexit process seemingly rising, rather than decreasing, we do not believe that the current circumstances constitute the type of “conventional” environment —to borrow the terminology from Governor Mark Carney's latest [speech](#) - that would typically facilitate a more straightforward monetary policy decision between balancing above-target inflation against the risk of a weaker growth outcome. As such, we continue to believe that the MPC will remain on hold for the remainder of 2017 and in 2018, and argue that the expectation of policy tightening next year (as currently implied by market pricing) will likely, in our view, face greater scrutiny should rates remain unchanged this year and headline inflation begin to fall back from Q4-17, as we currently expect.

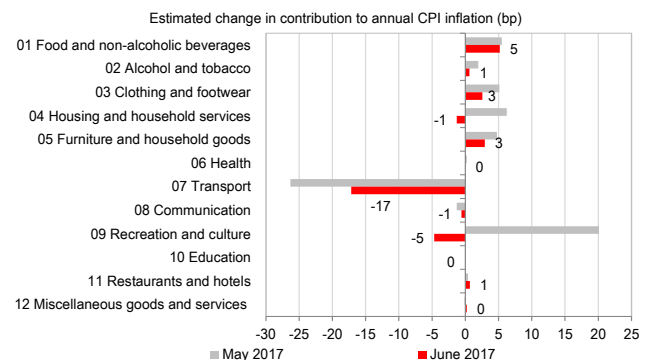
## Headline and core inflation expected to fall back in June

Moving away from the outlook for growth, we look for generally below-consensus inflation figures for June to be revealed for the UK in this morning's release. Indeed, we forecast the annual rate of CPI inflation falling to 2.8%, from 2.9% in May, and core CPI inflation also declining on the month, to 2.5%, from 2.6% previously. This decline is also expected to emerge on an RPI basis, where we look for the headline annual rate of inflation to slip to 3.6%, from 3.7% previously — with an index number of 272.6 expected— while we see RPIX inflation slowing to 3.8%, from 3.9% previously.

## Petrol prices again seen as a key negative in June....

In terms of the breakdown of the anticipated change in inflation, we expect most of the major components to make either a small positive or negligible contribution in June, with the transport and recreation & culture areas of the index making significant negative contributions on the month, forcing inflation lower overall as a result (see Chart 1).

**Chart 1: We expect the transport and recreation & culture components to force UK inflation lower in June**



Source: ONS, Thomson Reuters Datastream, Santander

Note: Chart shows the projected basis point change in contribution to the annual rate of UK CPI inflation by key index groups. Figures detail anticipated change in inflation contribution by each component in the June 2017 release.

We estimate that UK petrol prices fell by 1.1% on a CPI basis in June and rose by 0.08% on an RPI basis during the month, which, if confirmed, would directly reduce the annual rates of CPI and RPI inflation by 11bp and 9bp, respectively. Indeed, based on the latest available weekly petrol price data in the UK, we believe that similarly negative contributions should also be expected from this area within the July data. Petrol aside, some further weakness within the transport area is also expected from the air fares category (other travel costs within the RPI) in June. Although this particular area of the inflation indices remains extremely volatile and, consequently, difficult to forecast on a month-to-month basis, we note that record monthly prices



increases were registered on both a CPI and an RPI basis in June last year, and so we believe that base effects could lead to this component dragging on UK inflation in June 2017.

### ... with base effects in recreation & culture, as well as air fares, also seen important

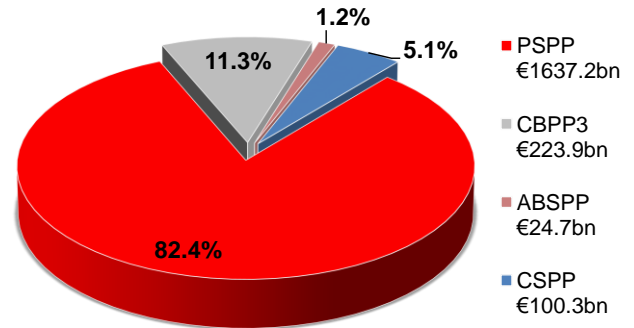
Elsewhere, we also look for the recreation & culture component to surrender a degree of the strength seen in May, and would again note that the audio & visual equipment and recreational and cultural services components of the UK's CPI (COICOP classes 9.1 & 9.4) –which, together, added an additional 7bp to the annual rate of inflation in May 2017– also registered record monthly gains in June 2016.

To a large extent, we believe that the out-size, positive contribution to CPI inflation seen from the recreation & culture component in the May release (+20bp) represented a front-loading of price increases and a shift in seasonality relative to 2016, rather than the emergence of a more marked and consistent inflationary trend in the UK. Together with our expectations around petrol prices, this assumption is key to our call for a decline in both the headline and core rates of UK CPI inflation in June. And, taken as a whole, we expect this morning's release to again suggest that the acceleration of UK inflation continues to reflect externally and not domestically-generated price pressures. Meanwhile, on an RPI basis, we look for the housing depreciation element to reduce the annual rate of RPI inflation by 1bp in June, which, although not typically worthy of highlighting, would (if confirmed) strike a contrast with the 3bp positive contribution seen in May.

### Update on the ECB's EAPP: CSPP above the €100bn mark

Yesterday, the ECB published an update of its [Extended Asset Purchase Program](#) holdings, covering the purchases settled as at 14 July for all its purchase programmes (PSPP, CBPP3, ABSPP and CSPP). According to the ECB's latest figures, last week's purchases (€16.3bn) continue to show an faster pace than last month's weekly average (€12.5bn) and the weekly average since the beginning of April (€14.3bn), confirming a frontloading effort before the summer break (recall that last week's report showed an increase of €17.1bn, much higher than the €6bn reported at the end of June). Additionally, looking at the amounts accumulated, the CSPP surpassed the €100bn mark for the first time, and the ECB's entire QE programme is now just €14bn shy of the €2trn mark.

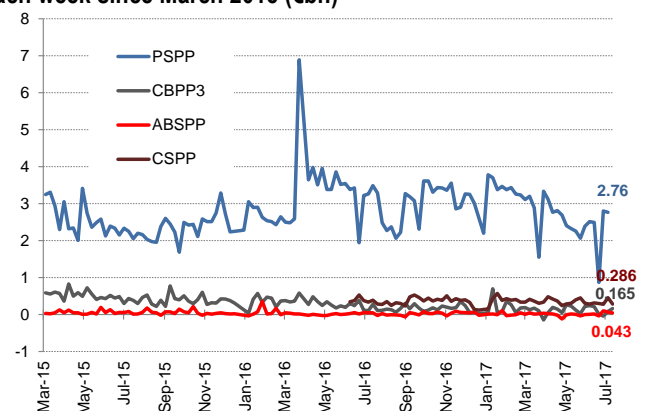
Chart 2: The ECB's EAPP portfolio: €1,986.1bn



Source: ECB, Bloomberg, Santander.

**PSPP holdings** now stand at €1,637.2bn, an increase of €13.8bn on the previous week (last week's rise was €14bn). Looking at the five-working-day average, the daily pace of sovereign bond purchases slowed last week, to €2.76bn under the PSPP (from the €2.80bn reported last week). While less than the accumulated daily average of €2.79bn since the programme got underway back in March 2015, this still exceeds the daily average since the beginning of last April (€2.51bn). The ECB's **CBPP3 holdings** now amount to €223.9bn, €0.8bn more than last week and above the €0.4bn growth reported last week. The daily purchasing average under the CBPP3 accelerated to €165mn (from the €83mn reported last week). The **CSPP** shows holdings of €100.3bn, an increase of €1.4bn after the €2.3bn growth posted in last week's ECB report. The five-working-day average shows that the ECB bought €286mn per day of corporate bonds (vs. the €457mn average posted last week). And the **ABSPP holdings** have reached €24.7bn, just €216mn more than the figure posted a week earlier (and slightly lower than the €349mn rise seen last week). Here the daily average declined to €43mn, from €70mn last week.

Chart 3: The ECB's EAPP portfolio: average daily purchases each week since March 2015 (€bn)



Source: ECB, Bloomberg, Santander.



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