The views expressed in this report, which has been prepared for our clients, represent the independent views of the research analysts who authored this report and do not reflect the views of Banco Santander SA.

29 June 2016

MACRO MARKETS DAILY

Economic data today

- **Spain June Preliminary CPI** (exp. -0.9% YoY, last -1.0% YoY). We anticipate similar annual rates for June as those seen in May for both energy (-14.0%) and food (2.6%), so the key to a modest rise in total inflation might lie in the performance of core inflation (we forecast 0.8% YoY from 0.7% YoY).
- **Germany June Preliminary CPI** (exp. 0.3% YoY, last 0.1% YoY). After the 'noise' in consumer prices due to Easter seasonality, we expect to see clear support from the services component to lift total inflation towards c1.5% YoY by the end of the year.
- **Euro zone June Economic Confidence** (exp. 104.7, last 104.7). Confidence outpaced expectations in May thanks to improved sentiment among companies in the industrial sector and households, which was more than enough to offset a slight deterioration in expectations in the services sector. Bearing in mind that production, new orders and employment rose, we expect another good reading for the economic confidence index in June to close a quarter where Euro zone GDP could attain another very decent pace of expansion, which we estimate at 0.5% QoQ in 2Q16 after 0.6% QoQ in 1Q16.
- **US May Personal Income** (exp. 0.3% MoM, last 0.4% MoM) **and Personal Spending** (exp. 0.4% MoM, last 1.0% MoM). Confirmation of the good trend in these indicators is key to sustaining our forecast of acceleration in US GDP as soon as 2Q16. We continue thinking that fundamentals for private consumption are still clearly supportive. **May Pending Home Sales** (exp. -1.1% MoM, last 5.1% MoM). Although quite volatile month-on-month, the real estate sector figures undoubtedly continue to show a clearly positive contribution to GDP growth.
- **Central bank speakers:** The Fed's Yellen as well as the ECB's Draghi, Lautenschlaeger and Constancio.
- **UK May Bank of England Mortgage Approvals** (fcst. 67.6k, last 66.3k), **Net Consumer Credit** (fcst. £1.5bn. last £1.3bn) **and Non-Residents' Net Gilt Holdings** (last +£214mn). The BBA's data suggests a slight increase in housing market activity in May, after April's stamp duty-related slowdown. Strong retail sales suggest that consumer credit was also growing well at the time.

Rates Strategy

- **EUR Rates:** Yesterday, a more sanguine tone in equities allowed risk premia to recover part of the ground lost in the previous sessions (Italy, at 151bp over the 10y Bund, tightened 11bp yesterday, but is still 14bp wider than last week) and, in the specific case of Spain, extend the post-election rally initiated on Monday (the 10y SPGB, at 143bp over Germany, was not only 14bp tighter on the day, but is already 3bp tighter than one week ago), outperforming Italy again (the spread has moved around 15bp in favour of Spain in the past two sessions). Interestingly, yesterday the risk-on sentiment did not entail significant selling pressure for Bunds (the 10y ended the day flat, at -0.11%), meaning that all the spread compression was caused by an actual rally in periphery govies.

- **UK rates:** Markets shrugged off the retrospective and unsurprising UK sovereign ratings downgrades with a modest swing back in a risk-on direction yesterday, with a 5bp rise in UK short rates and a 2.6% recovery in the FTSE 100 (mostly at the open, but extended through the session). The sell-off in gilts was strongest at 5y (4.5bp), with a little flattening of 5s10s and much more in the long end. This appeared to reflect more quarter-end buying, which meant 50y posted a 1bp

Antonio Villarroya
Head of Macro and Strategy Research
antvillarroya@gruposantander.com

José María Fernández
Rates Strategy
josemariafernandezl@gruposantander.com

Edgar da Silva
Rates Strategy
efda@gruposantander.com

Banco Santander, S.A.
(+34) 91 257-2244

Antonio Espasa
Chief Economist
aespasa@gruposantander.com
(+34) 91 289-3313

Laura Velasco
Economics
laura.velasco@gruposantander.com
(+34) 91 175-2289

Beatriz Tejero
Economics
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 Economics
Stuart.Green@santandergcb.com

Adam Dent
UK Rates Strategy
adam.dent@santandergcb.com

Banco Santander, S.A. London Branch
(+44) 20 7756-4111 / 6170 / 6223

Stuart Bennett
G-10 FX Strategy
stuart.bennett@santandergcb.com

Michael Flisher
G-10 FX Strategy
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*

Santander GLOBAL CORPORATE BANKING

Banco Santander, S.A. is registered in Spain and is authorised and regulated by Banco de España, Spain (C.I.F.:A39000013). Banco Santander, S.A. London Branch is registered in the UK (with FRN 136261) and subject to limited regulation by the FCA and PRA. Santander Investment Securities Inc. ("SIS") is a member of FINRA, US (CRD. nº 37216). US recipients should note that this research was produced by a non-member affiliate of SIS. For further disclosures please see the back of this report.

outright rally to a new record low yield (1.61% for the 68s). Gilt swap spreads also widened back a little, particularly the longs, appearing to highlight the irrelevance of the credit rating changes. This flattening support for the yield and spread curves could be expected to peter out by next week, once supply resumes and month-end extensions are complete. Linkers outperformed nominals, especially in the front end. This was helped by better risk appetite and a bounce in oil prices, but hindered by a slight recovery in the currency and resistance around -1.40% in ultra-long real yields.

FX Strategy

- The **NZD** was boosted overnight as Statistics New Zealand revised the Q1-16 unemployment rate lower, to 5.2%, from 5.7% previously. It should be noted that this improvement is due to a change in methodology, which no longer includes those looking at job ads on the internet as "actively" seeking work. Nevertheless, **NZD/USD** rose on this announcement, and sits at just below 0.71 this morning.
- After two days of heavy losses, Sterling posted gains yesterday, with **GBP/USD** temporarily touching above 1.34, and **EUR/GBP** dropping to 0.8300. Despite these partial gains, and as discussed in our latest FX Compass, published yesterday, we are now negative Sterling and expect the Pound to weaken in the coming months.
- **EUR/USD** also recovered a little yesterday, despite the release of a slightly firmer GDP print in the US. While consumer confidence data are released in the Eurozone today, and personal income and spending numbers are out in the US, we again expect the FX markets to continue to digest to impact of last week's Brexit vote and, therefore, to continue to move off general risk sentiment.

Summary of our FX views

Please see our FX Compass – June 2016 report, published yesterday for our latest forecasts and updated views on G10, LatAm and CEE FX. Below is a summary of our views on G10 FX.

We are no longer positive on **Sterling**. The UK's vote to leave the EU implies uncertainty and downside risks for the economy. Hence, we no longer expect a BoE rate hike in Q1-17, but rather see a rate cut in Q4-16. As such, we have changed our Sterling forecasts and now forecast **GBP/USD** at 1.25 by the end of 2016, rather than 1.58. We see **EUR/GBP** at 0.88 by year-end.

The **USD** outlook may be more mixed following the UK's Brexit vote. The Dollar is likely to gain on safe-haven demand, as the UK's decision to leave the EU is expected to keep global risk elevated. However, increased risk may also imply that the Fed decides against hiking rates in 2016, and limit USD upside pressure.

We retain a relatively positive outlook on the **EUR** through to the end of 2016, but downside risks have clearly increased in the aftermath of the Brexit vote. The UK's decision to start the process of leaving the EU will likely have a negative impact on the Eurozone economy. However, the hit that this implies for **EUR/USD** could be countered by the expectation that Brexit suggests the Fed will now be reluctant to hike rates in 2016.

Global risk will remain a focus for the **Yen**, at least for the time being. Whilst this implies upside pressure on the Yen via safe-haven flows, it also puts the spotlight back on to monetary policy. The Brexit-related risks suggest that the Fed may postpone US rate hikes beyond 2016, which should be **USD/JPY** negative. However, an even stronger Yen, and the risk that this could weigh on CPI in Japan, may increase the prospect of more easing from the BoJ.

We remain positive on the **CAD** and **NOK**, but still expect only small gains during the remainder of 2016. The recent rise in the oil price has helped both currencies, but they are likely to require a much stronger oil price to rise significantly higher in H2-16.

The SNB still views the **CHF** as "heavily overvalued" and intervened to weaken it following the Brexit vote. A sustained rise in **EUR/CHF** would probably now require a firmer EUR and further SNB action.

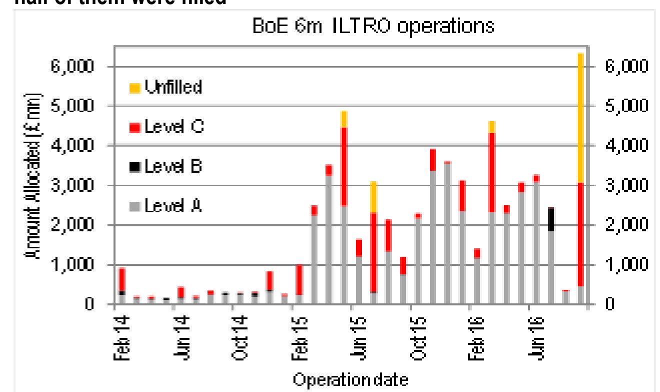
We remain negative both the **AUD** and **NZD**. Following the Brexit vote, expectations for near-term rate cuts from the RBA and RBNZ have risen. Q2-16 CPI data are released in both Australia and New Zealand in July. Even weaker inflation could prompt sooner-than-expected rate cuts, and thus AUD or NZD weakness.

Bank of England repo operation

Yesterday, the BoE conducted the last of its additional 6m Index Long-Term Repo Operations (ILTROs). These are regular, monthly liquidity operations, but the Bank had scheduled additional, weekly ones around the date of the EU referendum. This was intended to reassure financial institutions –and markets– that there will be ample liquidity available in the event of any market turbulence and, therefore, to hopefully prevent any disruption from even occurring. Note that the operation is Bank rate-linked, so participants would still benefit in the event of cuts from the MPC.

Some £3.1bn of liquidity was allocated –slightly below the recent March high of £4.3bn and matching the £3.1bn seen in May– but the level of demand in this operation proved higher, totalling £6.3bn versus the £4.6bn seen back in March. This gave the lowest-ever fill ratio, 49% (Chart 1).

Chart 1: The latest ILTRO received the largest-ever bids, but less than half of them were filled



Source: Bank of England, Santander

Interestingly, the demand in this latest auction was seen mainly against Level C collateral (the weakest form), with bids in this category totalling £5.9bn, again much higher than the £2.3bn seen in this category back in March. This is also the first time that the clearing spread over Bank Rate for accepted Level C bids (of 20bp) was above its 15bp floor. All successful bidders for cash versus the same collateral level receive the same “clearing” spread, suggesting that (determined) bids at ≥20bp were accepted, but £3.3bn of (more relaxed) bids at the typical 15bp spread were declined.

So, all in all, the focus of the bids in this ILTR appear to be the more interesting feature of these results. And it will, of course, be interesting to see if the Bank of England feels the need to schedule further ILTR operations over and above the typical monthly pattern, which resumes on 5 July. That next operation will deliver six-month funding that lasts over year-end, giving it an additional appeal versus the June operations, including yesterday’s, which all mature on 8 December.

Important Disclosures

ANALYST CERTIFICATION:

The views expressed in this report accurately reflect the personal views of the undersigned analyst(s). In addition, the undersigned analyst(s) has not and will not receive any compensation for providing a specific recommendation or view in this report:

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

The analysts referenced in connection with the section for which he or she is responsible may have received or will receive compensation based upon, among other factors, the overall profitability of the Santander group, including profits derived from investment banking activities.

EXPLANATION OF THE RECOMMENDATION SYSTEM

DIRECTIONAL RECOMMENDATIONS IN BONDS		DIRECTIONAL RECOMMENDATIONS IN SWAPS	
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.

RELATIVE VALUE RECOMMENDATIONS	
Rating	**Definition**
Long a spread / Play steepeners	Enter a long position in a given instrument vs a short position in another instrument (with a longer maturity for steepeners) for an expected average return of at least 5bp in 3 months (increase in the spread between both rates).
Short a spread / Play flatteners	Enter a long position in a given instrument vs a short position in another instrument (with a shorter maturity for flatteners) for an expected average return of at least 5bp in 3 months (decline in the spread between both rates).

FX RECOMMENDATIONS	
Rating	**Definition**
Long / Buy	Appreciation of a given currency with an expected return of at least 5% in 3 months.
Short / Sell	Depreciation of a given currency with an expected return of at least 5% in 3 months.

NOTE: Given the recent volatility seen in the financial markets, the recommendation definitions are only indicative until further notice.

IMPORTANT DISCLOSURES

This report has been prepared by Banco Santander, S.A. and is provided for information purposes only. Banco Santander, S.A. is registered in Spain and is authorised and regulated by Banco de España, Spain.

This report is issued in the United States by Santander Investment Securities Inc. (“SIS”), in Spain by Banco Santander, S.A., under the supervision of the CNMV and in the United Kingdom by Banco Santander, S.A., London Branch (“Santander London”). SIS is registered in the United States and is a member of FINRA. Santander London is registered in the United Kingdom (with FRN 136261, Company No. FC004459 and Branch No. BR001085), and subject to limited regulation by the UK’s Financial Conduct Authority (“FCA”) and Prudential Regulation Authority (“PRA”). SIS, Banco Santander, S.A. and Santander London are members of Santander Group. A list of authorised legal entities within Santander Group is available upon request.

This material constitutes “investment research” for the purposes of the Markets in Financial Instruments Directive and as such contains an objective or independent explanation of the matters contained in the material. Any recommendations contained in this document must not be relied upon as investment advice based on the recipient’s personal circumstances. The information and opinions contained in this report have been obtained from, or are based on, public sources believed to be reliable, but no representation or warranty, express or implied, is made that such information is accurate, complete or up to date and it should not be relied upon as such. Furthermore, this report does not constitute a prospectus or other offering document or an offer or solicitation to buy or sell any securities or other investment. Information and opinions contained in the report are published for the assistance of recipients, but are not to be relied upon as authoritative or taken in substitution for the exercise of judgement by any recipient, are subject to change without notice and not intended to provide the sole basis of any evaluation of the instruments discussed herein.

Any reference to past performance should not be taken as an indication of future performance. This report is for the use of intended recipients only and may not be reproduced (in whole or in part) or delivered or transmitted to any other person without the prior written consent of Banco Santander, S.A..

Investors should seek financial advice regarding the appropriateness of investing in financial instruments and implementing investment strategies discussed or recommended in this report and should understand that statements regarding future prospects may not be realised. Any decision to purchase or subscribe for securities in any offering must be based solely on existing public information on such security or the information in the prospectus or other offering document issued in connection with such offering, and not on this report.

The material in this research report is general information intended for recipients who understand the risks associated with investment. It does not take into account whether an investment, course of action, or associated risks are suitable for the recipient. Furthermore, this document is intended to be used by market professionals (eligible counterparties and professional clients but not retail clients). Retail clients must not rely on this document.

To the fullest extent permitted by law, no Santander group company accepts any liability whatsoever (including in negligence) for any direct or consequential loss arising from any use of or reliance on material contained in this report. All estimates and opinions included in this report are made as of the date of this report. Unless otherwise indicated in this report there is no intention to update this report.

Banco Santander, S.A. and its legal affiliates (trading as Santander and/or Santander Global Corporate Banking) may make a market in, or may, as principal or agent, buy or sell securities of the issuers mentioned in this report or derivatives thereon. Banco Santander, S.A. and its legal affiliates may have a financial interest in the issuers mentioned in this report, including a long or short position in their securities and/or options, futures or other derivative instruments based thereon, or vice versa.

Banco Santander, S.A. and its legal affiliates may receive or intend to seek compensation for investment banking services in the next three months from or in relation to an issuer mentioned in this report. Any issuer mentioned in this report may have been provided with sections of this report prior to its publication in order to verify its factual accuracy.

ADDITIONAL INFORMATION

Banco Santander, S.A. or any of its affiliates, salespeople, traders and other professionals may provide oral or written market commentary or trading strategies to its clients that reflect opinions that are contrary to the opinions expressed herein. Furthermore, Banco Santander, S.A. or any of its affiliates' trading and investment businesses may make investment decisions that are inconsistent with the recommendations expressed herein.

No part of this report may be copied, conveyed, distributed or furnished to any person or entity in any country (or persons or entities in the same) in which its distribution is prohibited by law. Failure to comply with these restrictions may breach the laws of the relevant jurisdiction.

Investment research issued by Banco Santander, S.A. is prepared in accordance with the Santander group policies for managing conflicts of interest. In relation to the production of investment research, Banco Santander, S.A. and its affiliates have internal rules of conduct that contain, among other things, procedures to prevent conflicts of interest including Chinese Walls and, where appropriate, establishing specific restrictions on research activity. Information concerning the management of conflicts of interest and the internal rules of conduct are available on request from Banco Santander, S.A..

COUNTRY & REGION SPECIFIC DISCLOSURES

U.K. and European Economic Area (EEA): Unless specified to the contrary, issued and approved for distribution in the U.K. and the EEA by Banco Santander, S.A. Investment research issued by Banco Santander, S.A. has been prepared in accordance with Grupo Santander's policies for managing conflicts of interest arising as a result of publication and distribution of investment research. Many European regulators require that a firm establish, implement and maintain such a policy. This report has been issued in the U.K. only to persons of a kind described in Article 19 (5), 38, 47 and 49 of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (all such persons being referred to as "relevant persons"). This document must not be acted on or relied on by persons who are not relevant persons. Any investment or investment activity to which this document relates is only regarded as being provided to professional investors (or equivalent) in their home jurisdiction. **United States of America (US):** This report is being distributed to US persons by Santander Investment Securities Inc ("SIS") or by a subsidiary or affiliate of SIS that is not registered as a US broker dealer, to US major institutional investors only. Any US recipient of this report (other than a registered broker-dealer or a bank acting in a broker-dealer capacity) that would like to effect any transaction in any security or issuer discussed herein should contact and place orders in the United States with the company distributing the research, SIS at (212) 692-2550, which, without in any way limiting the foregoing, accepts responsibility (solely for purposes of and within the meaning of Rule 15a-6 under the US Securities Exchange Act of 1934) under this report and its dissemination in the United States. US recipients of this report should be advised that this research has been produced by a non-member affiliate of SIS and, therefore, by rule, not all disclosures required under NASD Rule 2711 apply. **Hong Kong (HK):** This report is being distributed in Hong Kong by a subsidiary or affiliate of Banco Santander, S.A. Hong Kong Branch, a branch of Banco Santander, S.A. whose head office is in Spain. The 1% ownership disclosure satisfies the requirements under Paragraph 16.5(a) of the Hong Kong Code of Conduct for persons licensed by or registered with the Securities and Futures Commission, HK. Banco Santander, S.A. Hong Kong Branch is regulated as a Registered Institution by the Hong Kong Monetary Authority for the conduct of Advising and Dealing in Securities (Regulated Activity Type 4 and 1 respectively) under the Securities and Futures Ordinance. The recipient of this material must not distribute it to any third party without the prior written consent of Banco Santander, S.A. **Japan (JP):** This report has been considered and distributed in Japan to Japanese-based investors by a subsidiary or affiliate of Banco Santander, S.A. - Tokyo Representative Office, not registered as a financial instruments firm in Japan, and to certain financial institutions defined by article 17-3, item 1 of the Financial Instruments and Exchange Law Enforcement Order. Some of the foreign securities stated in this report are not disclosed according to the Financial Instruments and Exchange Law of Japan. There is a risk that a loss may occur due to a change in the price of the shares in the case of share trading and that a loss may occur due to the exchange rate in the case of foreign share trading. **China (CH):** This report is being distributed in China by a subsidiary or affiliate of Banco Santander, S.A. Shanghai Branch ("Santander Shanghai"). Santander Shanghai or its affiliates may have a holding in any of the securities discussed in this report; for securities where the holding is greater than 1%, the specific holding is disclosed in the Important Disclosures section above.

For further country and region specific disclosures please refer to Banco Santander, S.A..

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
Brussels Tel: 32 2 286 5447 Fax: 32 2 230 6724	**Paris** Tel: 33 15353 7000 Fax: 33 15353 7060	**Frankfurt** Tel: 49 6959 67-6403 Fax: 49 6959 67-6407	**Tokyo** Tel: 813-5561-0591 Fax: 813-5561-0580
New York Tel: 212-756-9160 Fax: 212-407-4540	**Bogota** Tel: 571-644-8008 Fax: 571-592-0638	**Buenos Aires** Tel: 54114-341-1052 Fax: 54114-341-1226	**Caracas** Tel: 582-401-4306 Fax: 582-401-4219
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

Grupo Santander ©. 2016. All Rights Reserved.

Santander GLOBAL CORPORATE BANKING