



RBC Capital Markets

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RBC European Rates & Economics Daily

- **Overnight news:** BoE Carney on no-deal Brexit; Italy's Di Maio on budget; Canada's Trudeau on NAFTA
- **Data and events:** Euro area labour costs; BoE's Carney speaks
- **Market outlook:** 10y US-EUR spread remains a good 'positive carry' short
- **BoE and ECB meetings:** BoE on hold awaiting Brexit outcome, but Draghi made the rest of the year a little more interesting for the ECB
- **What to Watch For:** The Week Ahead in Europe

Overnight news: Asian equities were mainly higher for a second day running buoyed by expectations that trade talks between the US and China were set to resume; Chinese officials were said to have welcomed an earlier invitation from Treasury Secretary Mnuchin for a fresh round of talks. Yesterday's action from the Turkish Central Bank, which raised its benchmark interest rate to 24% from 17.5%, also supported risk sentiment. The dollar cooled on the back of yesterday's disappointing US CPI data, DXY is down -0.2%. 10-year Treasury yields were steady at 2.97%. Oil continued to sit at just below \$70 b/l (WTI crude).

A number of this morning's UK newspapers cover **BoE Governor Mark Carney's** assessment of the impact of a no-deal Brexit which he gave to the UK government at yesterday's cabinet meeting. According to the reports, Carney likened its impact to that of the 2008/09 financial crisis and is also said to have warned that a disorderly exit would lead to a fall in GBP and higher tariffs pushing inflation higher, making it harder for the Bank to cut rates to support the economy as it did in the aftermath of the 2016 referendum, something Carney first pointed out in his testimony to the Treasury Select Committee last week.

In an interview with Spanish newspaper El Mundo, **Italian Deputy PM and 5-Star leader Luigi di Maio** said that he doesn't 'contemplate the possibility of Italy leaving the EU' but added that the EU itself needed 'a profound reform'. On the forthcoming Italian budget he said that the time has come to have 'expansive [fiscal] policies' but also said that the government wouldn't 'destroy' the public finances.

Canadian PM Justin Trudeau, speaking yesterday, said that he wanted a deal on NAFTA as soon as possible but refused to confirm whether an end of September deadline had been set for concluding the talks.

Data and events: The data calendar is relatively light today. Following on from yesterday's ECB meeting, this morning euro area labour costs data will be watched for signs that euro area wage growth is firming as per the ECB's assessment.

Also this morning, BoE Governor Mark Carney is in Dublin to give the annual Whitaker lecture organized by the Irish Central Bank. The Bank of England will release the text of his speech at 11am.

Region	BST	Period	Data/Event	RBC	Consensus	Prior
Italy	09:00	Aug	HICP y/y (%) (previous est: 1.7)		1.7	1.9
Euro area	10:00	Jul	Trade balance, sa (€bn)		16.2	16.7
Euro area	10:00	Q2	Labour costs, y/y (%)			2.0
UK	11:00	...	BoE Governor Mark Carney speaks in Dublin			
US	13:30	Aug	Retail sales headline, ex autos, control	0.4, 0.5, 0.4	0.4, 0.5, 0.4	0.5, 0.6, 0.5
US	14:15	Aug	Industrial production m/m (%)		0.3	0.1
US	15:00	Sep P	U Mich consumer sentiment	98	96.6	96.2

Sources: Bloomberg, Reuters and RBC Capital Markets estimates

All values in GBP unless otherwise noted.
 Priced as of prior trading day's market close (unless otherwise stated).

Market	Level	Chg**
Fixed Income		
TYZ8	119.39	-0.03
RXZ8	159.46	-0.17
G Z8	121.69	-0.19
2y UST	2.75%	0bp
5y UST	2.87%	0bp
10y UST	2.97%	0bp
30y UST	3.11%	0bp
2y Schatz*	-0.54%	0bp
5y OBL*	-0.15%	1bp
10y Bund*	0.42%	1bp
30y Bund*	1.09%	1bp
2y Gilt*	0.80%	1bp
5y Gilt*	1.10%	2bp
10y Gilt*	1.50%	2bp
30y Gilt*	1.86%	2bp
10y SP-GE*	105bp	-1bp
10y IT-GE*	253bp	-1bp
10y FR-GE*	31bp	0bp
Money Markets		
EONIA	-0.365%	1bp
1y1y EONIA	-0.16%	0bp
ERZ8	-0.30%	0bp
SONIA	0.70%	0bp
1y SONIA	0.98%	0bp
L Z8	0.85%	-1bp
Currencies		
EUR/USD	1.1696	0.001
GBP/USD	1.3119	0.001
GBP/EUR	1.1217	0.000
Equities & commodities		
S&P500	2,904	15
Dow	26,146	147
Euro Stoxx	3,334	7
FTSE100	7,282	-32
Nikkei	23,005	184
Oil (CO1)	\$78.33	0.15
Gold	\$1,205.24	3.75
VIX	12.37	-0.77

* Chg as of T-2 COB

** Chg as of T-1 COB

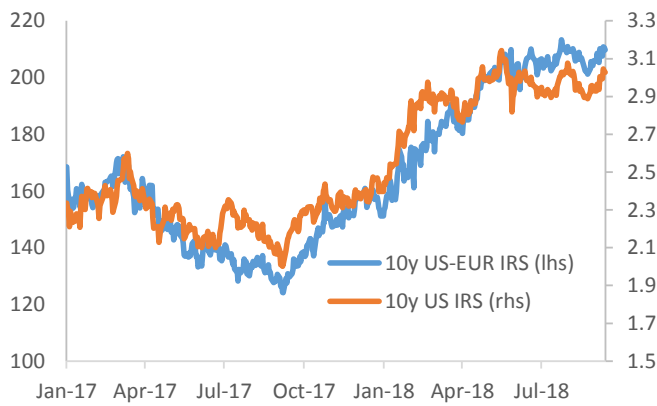
Levels as of Sep 14 05:59 GMT

Source: Bloomberg

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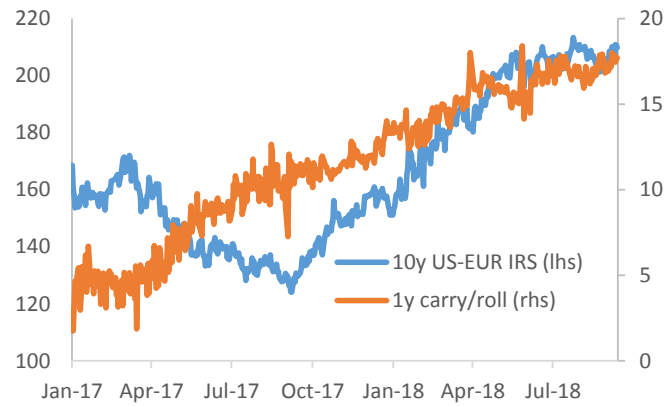
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Exhibit 1: 10y US IRS rate and spread versus EUR (in % and bp)



Sources: Bloomberg, RBC Capital Markets

Exhibit 2: 10y US-EUR IRS spread and 1y carry (in % and bp)

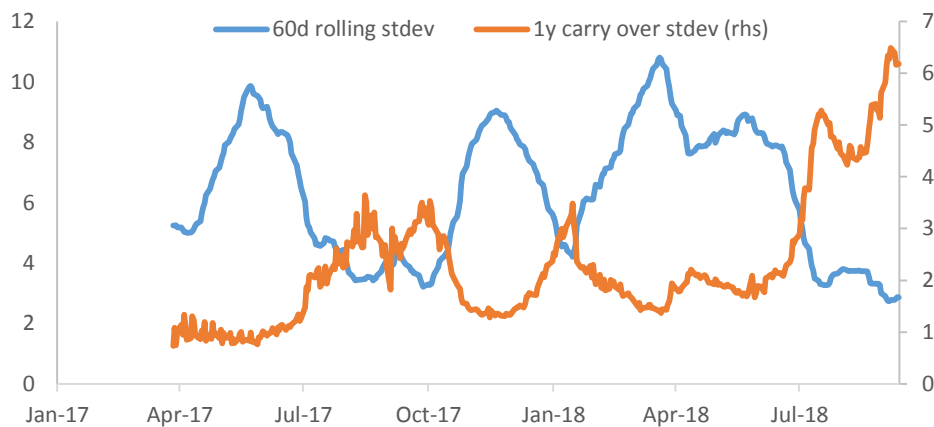


Sources: Bloomberg, RBC Capital Markets

Market outlook – 10y US-EUR spread remains a good ‘positive carry’ short: Despite yesterday’s small divergence between the US market (where bond yields dropped following the somewhat weaker-than-expected CPI figures) and the EUR market (where bond yields rose marginally), it should be noteworthy that the US-EUR spreads are already back to their most recent highs. Exhibit 1 illustrates using the 10y swap rates. We think this does not come as a surprise. As Exhibit 1 also illustrates the US market has been the driver of the spread for most of the previous years and only since the US yields started drifting sideways has the spread stopped widening. Over the last few days we repeatedly argued that we expect bond yields to rise going into year end and that this should – once again – be driven out of the US. We would in that case expect the spread to break towards new highs.

That all being said, a counterargument might be that we could be wrong and bond yields might well continue to drift sideways. Even in that case, being short the US versus the EUR market makes sense, however. As we have also repeatedly pointed out, the forward spreads are substantially tighter owing to the fact that the US curve is much flatter than the EUR curve. In other words, US-EUR spread wideners are positive carry – and by quite a margin. Exhibit 2 shows the 10y spread on the swap curve as well as the 1y carry/roll, ie, the difference between the 1y forward and the current spot spread. As can be seen, this difference sits at quite wide levels.

Exhibit 3: 60d rolling standard deviation of 10y US-EUR IRS spread and volatility-adjusted carry



Source: Bloomberg, RBC Capital Markets

Even more interesting, however, we think is the fact that this carry advantage has become more valuable owing to the low interest rate volatility observed. Exhibit 3 shows the 60-day rolling standard deviation of the 10y spread as well as the carry/roll in a ratio to the standard deviation, ie, a crude measure of a Sharpe Ratio. As seems logical, the combination of increasing carry and falling volatility in the spread has pushed this relative ratio to very high levels indeed.

For markets, we thus think staying in spread wideners remains a very attractive trade. In our base case, we could easily see some 10-20bp widening going into year-end as the market adjusts for higher expected inflation and Fed rates, while the ECB path should remain unaltered (see also below). Even if this is not the case, we think the (volatility adjusted) carry is likely to be clocked providing substantial cushion if our base case scenario does not pan out. This also presents a very attractive feature of a trade that represents (in empirical terms) effectively an outright short on the US markets – as Exhibit 1 already illustrated. However, it is an outright short with a positive carry whilst the ‘plain’ short only offers the opposite and would thus have cost quite a bit of P/L over the last months of sideways trading.

BoE and ECB meetings: Yesterday’s meetings of the Bank of England and European Central Bank saw both firmly on hold, outcomes widely expected in advance.

As we noted in our review of the [Bank of England’s MPC meeting](#), though the economic data in the UK remains firm, both GDP growth and wages are a little ahead of what the MPC expected at the time of the August IR, Brexit is the biggest single influence on the BoE’s next policy move.

In the meeting minutes, the MPC noted that since August there had been “greater uncertainty about future developments in the withdrawal process”, the Bank’s way of saying that fears of the UK leaving the EU without a deal Brexit had risen.

Until the outcome of negotiations between the EU and UK becomes clearer the Bank will remain on hold. However, with the deadline for the EU and UK to reach agreement pushed back to mid-November, the MPC may be little wiser as to what form Brexit will take at the time of the next IR on November 1st.

For the ECB, there were a few loose ends to tie up which we discuss in our [post-Governing Council meeting note](#). The only change to the forward guidance was to ‘update’ to the part pertaining the path of QE purchases, the ECB just confirming that it will go ahead with the reduction to EUR 15bn/month from October onwards.

There was still no firm steer on how the reinvestment policy would operate though President Draghi did say that the ECB would make a declaration at one of its two remaining meetings this year. With the ECB having set its policy course for deep into 2019 that should at least mean there will be some take-away for markets from this year’s remaining meetings.

Otherwise there was very little to excite, despite the advance headlines, the changes to the staff forecasts were marginal. GDP growth was revised down 0.1ppts in 2018 and 2019 (to 2.0% and 1.8%, respectively) but the inflation forecasts were left as was, with staff continuing to project HICP inflation of 1.7% over 2018-20.

What To Watch For: The Week Ahead in Europe

- **UK inflation (Wed):** In July it was the transport category that made the largest upward contribution to CPI inflation. Fuel prices rose again last month, meaning that should continue to be the case in the August. However, with the year-on-year increase in pump prices easing and the pass-through to prices from previous falls in GBP continuing to fade, we see CPI inflation falling slightly to 2.4% y/y this month from 2.5% y/y previously. The big surprise in July was, however, the narrowing of the CPI-RPI wedge to -0.76ppts, particularly recent BoE rate rises mean that the pressure should be toward a widening of the wedge through higher mortgage interest payments. We anticipate that the narrowing of the wedge in July may have been a one-off and expect it to widen to 0.9ppts again this month with RPI inflation at 3.3% y/y.
- **Euro area 'flash' PMIs (Fri):** The September HIS/Markit 'flash' PMIs will mean that we have a (close to) full set of Q3 PMIs for the euro area, France and Germany. However, the more interesting aspect of the 'flash' release may be in what they tell us about the countries that are not covered; Italy and Spain. Though not directly covered in the 'flash' release, we can infer from the German, French and euro area PMIs the broad direction of travel in the two. At present the PMIs are pointing to a slowdown in Spain and Italy. That is more manageable for Spain, where q/q growth rates have averaged 0.8% q/q over the past four years, but suggests that the Italian economy is at risk of stagnating; at 51.7 the Italian composite PMI slipped below its long-run average last month.

Key non-European events

- **RBA September Minutes (Tues):** Following yet another steady rate decision, the minutes will likely cover a number of familiar themes – a return to above-trend growth, full employment and eventually a lift higher in core inflation. Key domestic data released since the 4 September Board Meeting have been consistent with this positive narrative, with a strong Q2 GDP print and healthy August labour force report. Comments from the board dinner that evening may be elaborated upon in the minutes with the RBA likely to highlight that it is watching a number of global uncertainties (trade, US inflation, EM), the moderating housing market, and noting some uncertainty around the degree of slack in the labour market.
- **Canada CPI (Fri):** We see a 0.2% m/m decline in headline CPI in August after a surprise +0.5% m/m print in July that took the YoY rate to a more than six-year high of 3.0%. The monthly print was driven by a 15.4% m/m increase in inter-city transportation (airfares) that looks likely due to methodology changes, with a reversal of about one-third of that gain expected in August. A 2.0% m/m decline in gas prices should also pressure the monthly change into negative territory. Gas prices will still be up ~20% y/y (contributing ~0.7pp to headline inflation) and a big reason why the BoC sees the rise to the top-end of its target range as "transitory". The core measures are a much better gauge of underlying inflation pressures and should stay around the 2.0% level on average for the seventh consecutive month.

Data and Events Calendar

MONDAY 17									
Region	EDT	BST	AEST	Period	Data/Event	RBC	Consensus	Prior	
UK	19:01+	00:01	09:01	Sep	Rightmove house prices m/m, y/y (%)			-2.3, 1.1	
Italy	04:00	09:00	18:00	Jul	Trade balance: total (€mn)			5071.0	
Euro area	05:00	10:00	19:00	Aug	HICP m/m, y/y (%) (previous est: 0.2, 2.0)			-0.3, 2.1	
Canada	08:30	13:30	22:30	Jul	Int'l Securities Transactions (C\$bn)			11.6	
US	8:30	13:30	22:30	Sep	NY Empire	20.0	23.0	25.6	
Canada	09:00	14:00	23:00	Aug	Existing Home Sales m/m (%)			1.9	
TUESDAY 18									
Region	EDT	BST	AEST	Period	Data/Event	RBC	Consensus	Prior	
Australia	21:30+	02:30	11:30	Q2	ABS House Price index, q/q (%)	-0.6		-0.7	
Australia	21:30+	02:30	11:30	Aug	RBA September Minutes				
Spain	03:00	08:00	17:00	Q2	Labour costs, y/y (%)			0.7	
Italy	04:00	09:00	18:00	Jul	Industrial orders m/m (%)			3.6	
Canada	08:30	13:30	22:30	Jul	Manufacturing Sales, m/m (%)	0.6		1.1	
WEDNESDAY 19									
Region	EDT	BST	AEST	Period	Data/Event	RBC	Consensus	Prior	
New Zealand	18:45	23:45	08:45	Q2	Current Account Deficit (NZ\$bn)			0.2	
Australia	21:30+	02:30	11:30	Aug	Westpac Leading Indec m/m (%)			0.0	
Australia	21:30+	02:30	11:30	Aug	Skilled Vacancies m/m (%)			0.2	
Australia	21:30+	02:30	11:30	...	AG Kent's speech - <i>Money Creation</i>				
UK	04:00	09:00	18:00	...	BoE Chief-Economist and MPC member Haldane speaks				
Euro area	04:00	09:00	18:00	Jul	ECB current account, sa (€bn)			23.5	
Italy	04:00	09:00	18:00	Jul	Current account (€mn)			5135.0	
UK	04:30	09:30	18:30	Aug	CPIH y/y (%)			2.3	2.3
UK	04:30	09:30	18:30	Aug	CPI m/m, y/y (%)		0.5, 2.4	0.0, 2.5	
UK	04:30	09:30	18:30	Aug	RPI m/m, y/y (%), index (level)		0.8, 3.3, 283.9	0.1, 3.2, 281.7	
UK	04:30	09:30	18:30	Aug	PPI input, output, output core y/y (%)			10.9, 3.1, 2.2	
UK	04:30	09:30	18:30	Aug	ONS house prices y/y (%)			3.0	
Euro area	05:00	10:00	19:00	Jul	Construction output m/m (%)			0.2	
US	8:30	13:30	22:30	Aug	Housing starts	1250k	1225k	1168k	
Euro area	09:00	14:00	23:00	...	ECB President Mario Draghi speaks in Berlin				
THURSDAY 20									
Region	EDT	BST	AEST	Period	Data/Event	RBC	Consensus	Prior	
New Zealand	18:45	23:45	08:45	Q2	GDP q/q (%)			0.5	
Switzerland	03:30	08:30	17:30	...	SNB interest rate decision (%)			-0.8	
Norway	04:00	09:00	18:00	...	Norges Bank interest rate decision (%)			0.5	
UK	04:30	09:30	18:30	Aug	Retail sales, ex auto m/m (%)			0.7, 0.9	
US	8:30	13:30	22:30	Sep	Philly Fed	20.0	15.0	11.9	
US	8:30	13:30	22:30	15-Sep	Initial jobless claims	210k		204k	
US	10:00	15:00	0:00#	Aug	Existing home sales	5.4m	5.37m	5.34m	
Euro area	10:00	15:00	0:00#	Sept	'Flash' consumer confidence index			-1.9	
FRIDAY 21									
Region	EDT	BST	AEST	Period	Data/Event	RBC	Consensus	Prior	
France	02:45	07:45	16:45	Q2	Wages q/q (%)			0.40	
France	02:45	07:45	16:45	Q2	GDP q/q, y/y (%) (previous est: 0.2, 1.7)			0.2, 2.2	
France	03:15	08:15	17:15	Sept	'Flash' PMI: manufacturing, services, composite index			53.5, 55.4, 54.9	
Germany	03:30	08:30	17:30	Sept	'Flash' PMI: manufacturing, services, composite index			55.9, 55.0, 55.6	
Euro area	04:00	09:00	18:00	Sept	'Flash' PMI: manufacturing, services, composite index	53.8, 54.1, ...		54.6, 54.4, 54.5	
Spain	04:00	09:00	18:00	Jul	Trade balance: total (€mn)			-2448.00	
UK	04:30	09:30	18:30	Aug	Public finances: PSNCR, PSNB ex Banking Groups (€bn)	..., 4.0		-19.2, -2.0	
Canada	08:30	13:30	22:30	Aug	CPI m/m, y/y (%)	-0.2, 2.8		0.5, 3.0	
Canada	08:30	13:30	22:30	Aug	CPI-Common, CPI-Median, CPI-Trim (%)			1.9, 2.0, 2.1	
Canada	08:30	13:30	22:30	Jul	Retail Sales, Ex Auto m/m (%)	0.3, 0.7		-0.2, -0.1	
Spain				Sovereign debt rating - S&P			A-, positive	
Greece				Sovereign debt rating - Moody's			B3, positive	

Variable release date, # Following day, + previous day.

Sources: Bloomberg, Reuters and RBC Capital Markets estimate

GBP and EUR Analytics*

Exhibit A: 3m Carry and Roll-down on the EUR swap curve

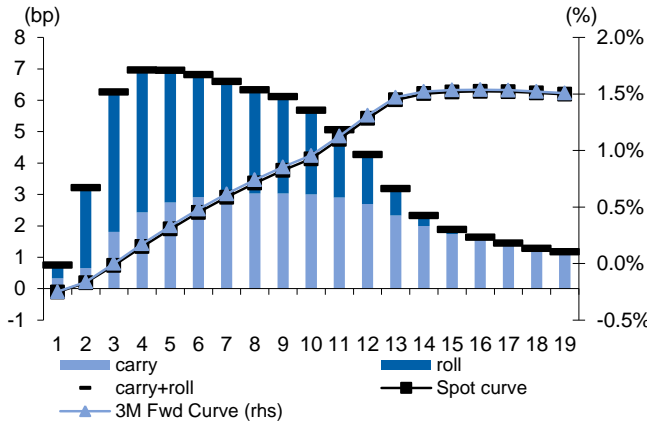


Exhibit B: 3m Carry and Roll-down on the GBP swap curve

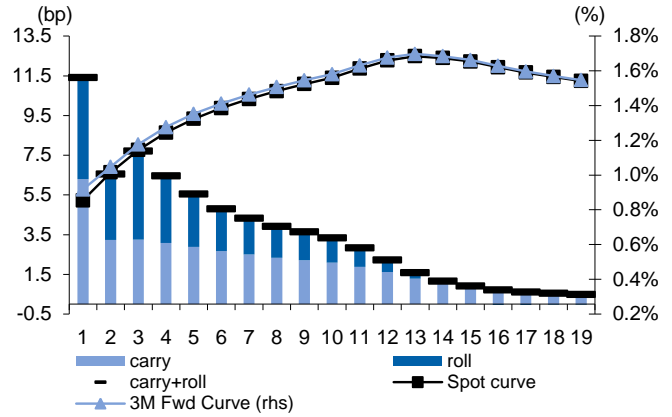


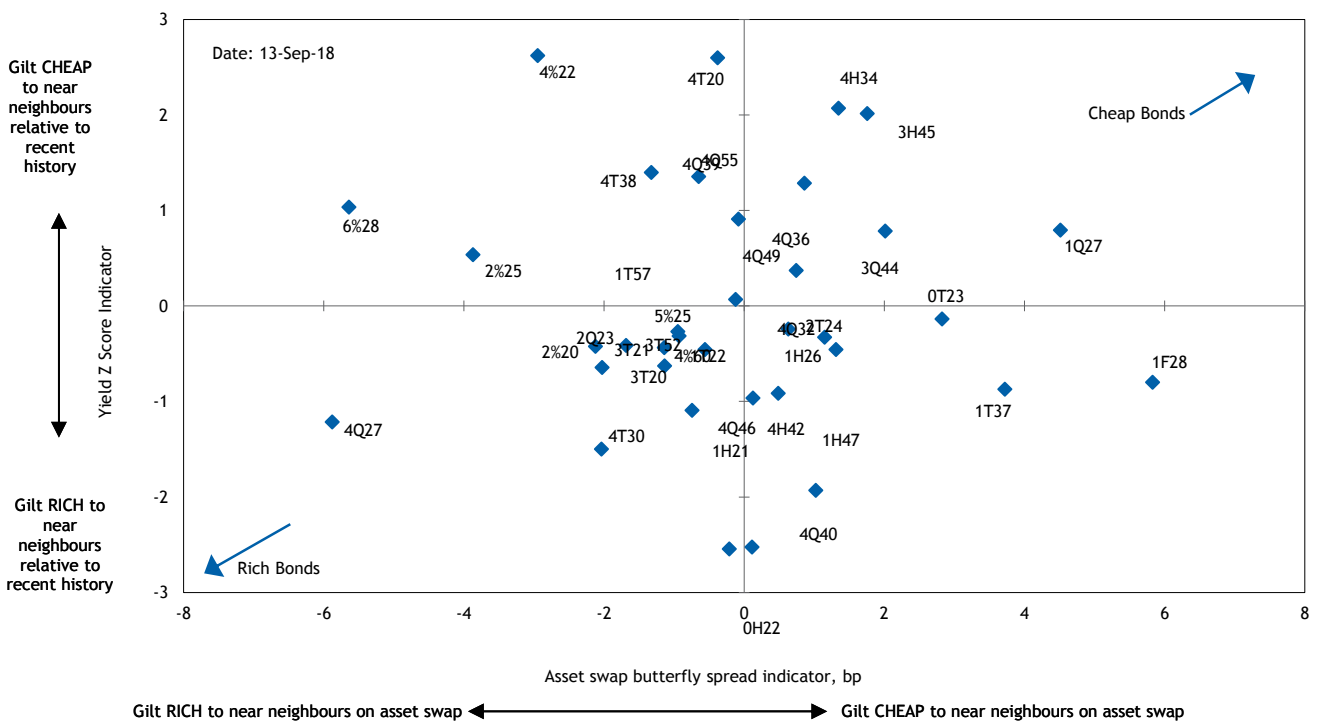
Exhibit C: Gilt micro butterflies (buy body v. sell wings), best trades per sector ranked by 30d z-score

	Butterfly (50/50)			Spread, bp	Z-score	
	Body	Short Wing	Long Wing		Z-score	Chg (7d)
1-7y	4T20	3T19	2%20	0.3	2.90	2.3 ▲
	4%22	1H21	1T22	-0.1	2.90	2.2 ▲
	4%22	3T21	0H22	-1.7	2.34	1 ▲
7-15y	1Q27	1H26	4Q27	7.4	1.41	0.8 ▲
	6%28	1F28	4T30	-9.4	1.26	0.2 ▲
	6%28	4Q27	4Q32	-6.2	0.80	0.9 ▲
>15y	4H34	4T30	1T37	3.1	2.51	2.2 ▲
	3H45	4H42	1H47	2.9	2.06	-0.6 ▼
	3H45	3Q44	4Q46	0.9	1.97	-1.6 ▼

Exhibit D: Gilt micro barbells (sell body v. buy wings), best trades per sector ranked by 30d z-score

	Barbell (50/50)			Spread, bp	Z-score	
	Body	Short Wing	Long Wing		Z-score	Chg (7d)
1-7y	2%20	4T20	3T20	-1.1	0.97	0.3 ▲
	3T21	1H21	4%22	-0.4	0.89	-0.1 ▼
	5%25	2T24	2%25	0.3	0.66	0.6 ▲
7-15y	4Q27	1H26	6%28	1.7	1.55	0.2 ▲
	4T30	1F28	4H34	5.0	1.54	-0.5 ▼
	4T30	6%28	4Q32	-2.1	1.46	0.3 ▲
>15y	1H47	3H45	3T52	-0.9	2.22	-0.5 ▼
	4Q40	4T38	3Q44	0.2	2.06	0.3 ▲
	4H42	4Q39	3H45	0.5	1.69	-0.4 ▼

Exhibit E: Gilt RV quadrant chart, 30d yield butterfly z-score, with asset swap butterfly indicator, bp ***



Source: RBC Capital Markets

* The above charts and tables draw on numerical analysis and do not necessarily represent our views and convictions ** Butterflies with the highest z-scores indicate the most attractive short-term switch opportunities out of the wings into the belly. The most negative z-scores indicate the best short-term opportunities to sell the belly into the wings *** The quadrant diagram combines two measures of relative value. On the horizontal axis the swap spread butterfly indicator is used and on the vertical axis the butterfly yield spread trading range z-score indicator is presented. The quadrant diagram has been designed to facilitate easy identification of rich and cheap bonds. The closer a bond is to the north-east vertex, the better value it represents versus its near neighbours. The closer a bond is to the south-west vertex, the worse value it represents versus its near neighbours. The most attractive switches should be those that involve selling a bond in the south-west quadrant into a bond in the north-east quadrant.
 September 14, 2018



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