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Spain not out of the woods yet

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Euro Government Bonds: Third Spanish election still possible - The Spanish centrist party Ciudadanos has decided to back the centre right party Partido Popular of acting Prime Minister Mariono Rajoy, however the country is not out of the political woods yet. Together with the support of the small conservative party Canarian Coalition, Mr Rajoy now controls a combined total of 170 congressional seats. Although this is an important victory for Mr Rajoy, the 170 seats still fall short of the 176 votes which are needed for an absolute majority at Wednesday's confidence vote. If Mr Rajoy does not succeed in securing enough votes, a second vote will take place on Friday in which only a simple majority is needed. A second vote could be won if Mr Rajoy would receive extra support from 6 Yes votes from other political parties or if 11 members of the congress would abstain from voting. If Mr Rajoy were not to succeed at this second vote, a two-month grace period will be held to form a government. If this attempt were also to prove unsuccessful, new elections need to be held. We judge the recent developments as positive, but still see significant risks which could continue the political stalemate. A new round of elections cannot be excluded. This and other political risks around the continent (not least in Italy), as well as the low probability that the ECB will drop its capital key as the system for country allocation in its QE programme, mean that we see peripheral spreads rising going forward. (Kim Liu)

Global FX: Not the beginning of a new dollar bull run - Since Fed Chair Yellen's comments last Friday (as well as the hawkish interpretation of the remarks by Vice Chair Fischer), the US dollar index has rallied by 1.3% as financial markets have increased the possibility of a Fed rate hike this year. Some investors have even speculated that a rate hike may come as soon as 21 September. As a result, precious metal prices, emerging market currencies and currencies of commodity exporters have suffered. These moves will likely accelerate if the US employment report would surprise on the upside again. This is because financial markets will increase the probability for a rate hike already in September. We think that the chance of a rate hike in September is not that high. Financial markets have currently priced in a 60% probability for a rate hike by the end of this year. This could increase further and provide some support to the US dollar. However, the upside in the dollar is limited in our view. Our base scenario suggests that US economic growth will remain moderate, improving only slightly in 2017. The growth/inflation mix is not supportive for the dollar, with inflation expected to be above growth. Meanwhile, real interest rates are forecast to remain negative. Overall, this is not a supportive combination for the dollar and we do not think recent strength marks the beginning of a new dollar bull run. (Georgette Boele)

US Macro: Inflation remains muted - The Fed's preferred measure of inflation, the personal consumption expenditure (PCE) deflator, edged down to 0.8% yoy in July from 0.9% the previous month, while core PCE (which is its targeted measure) was unchanged (it has been at 1.6% since March). The continued subdued trend in inflation should not be comforting for the Fed, since policymakers are looking for assurance that underlying inflation pressures are building up. Meanwhile, other US data showed that consumption will likely remain relatively robust in the third quarter. July's personal income rose 0.4% mom from 0.3% the previous month. As for personal spending, it increased by 0.3%, following a

0.5% rise in June. This suggests that US consumers continued spending, albeit at a slightly lower pace. The savings rate also released in this report, increased to 5.7% in July from 5.5% the prior month. The slightly higher reading indicates that households have become a bit more cautious in their spending. For inflation to pick up, firmer demand growth is needed. Overall economic growth has been weak keeping US inflation muted. A healthy labour market will likely support consumption growth ahead. Overall, though, the subdued inflation outlook means that the Fed can continue to raise interest rates at a snail's pace. (Maritza Cabezas)