

Global

# Weekly Watch

Madrid, 10 September 2010

## Economic Analysis

*Financial Scenarios*

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## The focus shift again towards European peripherals...

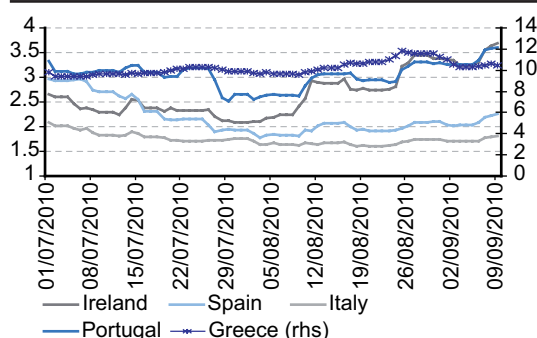
After some weeks of market jitters on the global cycle in which investors kept their eyes on the US economy and the reaction function of the Federal Reserve, the interest has shifted again towards European peripheral countries and more specifically to some parts of their banking system. Increasing worries about a second round of financial turmoil resurfaced on the back of arising problems in the Irish banking system. The systemic nature of Anglo Irish bank (the 3rd largest bank in Ireland, representing around 20% of its banking system) is likely to remain a concern for global investors, with sovereign spreads mounting in all peripherals although with a marked difference between Ireland and, to a lesser extent, Portugal, and the rest of Southern European economies. The spike in risk aversion registered in sovereign debt markets over the last few weeks is, however, still well below than the observed before the summer.

### ... while the global cycle gives a breath

The lack of relevant US data, with the exception of the international trade balance for July that surprised positively, has marked the developments in the macro front this week. In Europe, German prints showed more evidence that the German economy is slowing in Q3, after exports for July disappointed somewhat while core new orders remained strong. In Asia, the broad picture still reveals robust growth, with China's August imports surprising positively due to resilient domestic demand while some central banks in the region, primarily the Bank of Korea, decided to take a pause in a probably more cautious approach. Next week relevant market data include the US core CPI for August, a set of indicators in China on Saturday 11th and the Eurozone's exports for July.

Chart 1

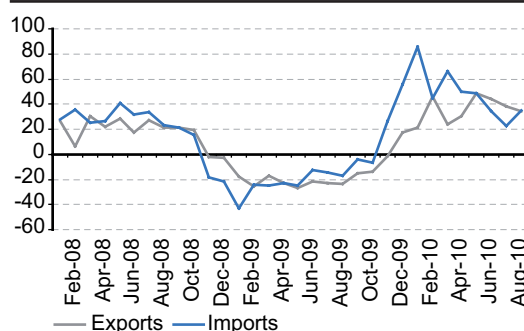
#### European countries: 2yr bond yield



Source: Bloomberg and BBVA Research

Chart 2

#### China: Exports and imports (y/y; current prices; nsa)



Source: Datastream and BBVA Research

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## Highlights

### European banks return to primary markets

A noticeable effervescence in European banks issuance has occurred over the last three weeks, but not for all. The key question remain whether bond markets will re-open for all institutions, especially for those with a most vulnerable profile.

### The US labour market in the doldrums

Contrary to the official view, recent evidence from labour reports suggest that unless the economy experiences a positive structural change like in the 90s an increasing problem of long-term structural unemployment might stay here for long.

## Markets Analysis

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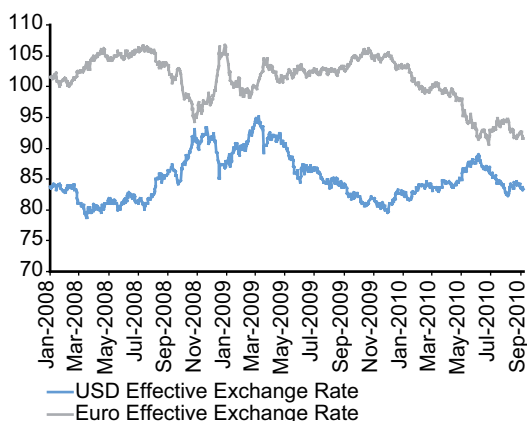
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## Markets still sceptical about a sustained improvement. We believe that the room on the upside for general rates is limited. Euro being shaped by the underlying risks in the Zone

The underlying market movements suggest that risk premiums continue their attempts at moderating: the main supporting elements are still a bright outlook for emerging economies and mostly the easing-off of the worst prospects regarding an impending, aggressive cyclical risk in the US. Whilst the recovery of the main risk assets underlines this profile (equities and commodities up by a further 3/4% during the last few days), there are some qualifications: i) the market is still particularly sensitive to any slightly disappointing data or news release, reacting with sharp corrections in some cases (short-term realized volatility is still high among these assets); ii) although yields are moving away from lows, they hardly have momentum to consolidate higher levels (10Y bonds just 20 bps up from late August lows); iii) risk elements are turning away from cyclical factors towards financial ones -especially in the Euro zone- while solvency and financing issues of some banking entities are still present; iv) in fact, the euro can hardly capitalize on an improvement against the dollar (it remains at the low end of its range at around EURUSD 1.27) at a time when the greenback is losing ground at a global scale (1% down in its effective exchange rate due to its role as a safe haven). These factors continue to be enough to remain cautious ahead of any fresh attempt at a further improvement by the markets. Still limited room on the upside for rates and for euro improvements.

Chart 3

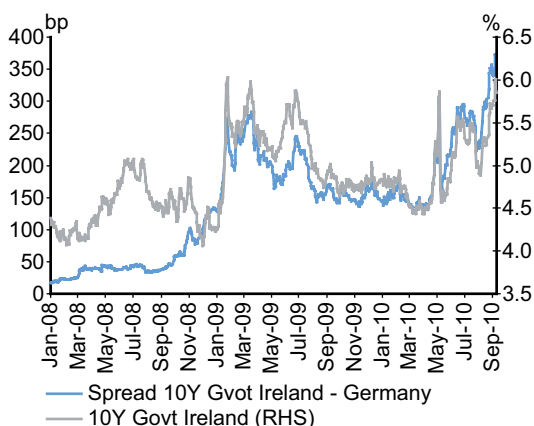
### EUR vs USD: Effective Exchange Rate



Source: Bloomberg and BBVA Research

Chart 4

### 10Y Govt Ireland vs Spread with Germany



Source: Bloomberg and BBVA Research

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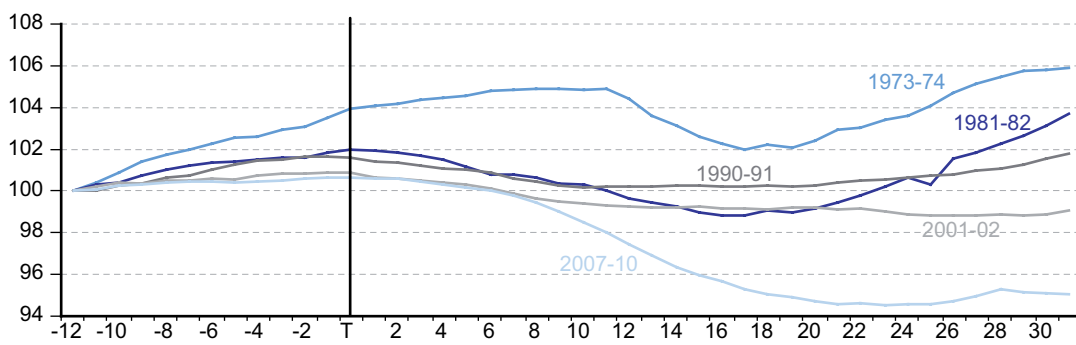
As expected around this time of the year, a noticeable surge in European banks issuance has taken place over the last three weeks, just after the usual summer break. In particular, some Spanish banks and savings banks took advantage of the window of opportunity following the stress test exercise in late July issuing more than €7 bn since then. Nonetheless, only a selected group of Spanish institutions have been able to tap primary markets, which leaves out around 45% of the Spanish financial system. This pick up in issuance activity for some Spanish institutions has certain characteristics: 1) most of new issuance revolves around covered bonds which grants more protection for bondholders than senior unsecured debt; 2) the maturity of the new debt issued is relatively short at around 3 years or so; and 3) new-issue spreads are extremely wide by past standards which increases the companies' funding cost. However, we note that this is partially compensated by very low all-in yields considering current swaps levels. Regarding the rest of the EMU, only the strongest institutions have been able to sell their bonds so far (in line with the Spanish case), but with longer maturities. In this context, while recent issuance activity is encouraging and has some positive implications, debt markets are still far from normalized. The key question remains whether bond markets will re-open more broadly for institutions and subnationals of peripheral countries going forward as a large amount of debt will have to be refinanced over the next 18 months.

**The US labour market in the doldrums**

Many concerns have been voiced about the US labour market over the last few weeks. For instance, during the last FOMC meeting, policymakers discussed a variety of ingredients that seem to be contributing to a slow private job growth. According to the minutes released, the ongoing uncertainty about a series of factors (e.g. regulation, taxes, healthcare cost) was cited as the main reason making firms remain reluctant to increase their workforces, thus being the gains from increased productivity growth, particularly since the end of 2008, the primary source to cope with renewed demand.

The US economy has lost more than 7 million jobs since the start of the crisis. A simple calculation shows that even if the economy could create 105K new jobs every month, it would take more than 4 years to recover all lost jobs in the recession. Nonetheless, with a growing population and labor force the US economy must create even more jobs than indicated by recent payroll data, therefore the spectre of rising long-term structural unemployment seems to gain credence. Contrary to what the Beige Book outlined this week, recent labour reports provide fresh evidence about this topic. For instance, the average number of weeks unemployed (33.6 in August) remain close to the maximum point of 35.2 weeks reached in June (16.5 week in December 2007) while the participation rate continues falling. Some alternative measures of labour underutilization such as the number of marginally attached and discouraged workers (i.e. people who are willing and able to engage in productive activities, but due to their lack of success believe that any effort to find a job will be fruitless so they have stopped seeking employment) also support this finding. The ratio of marginally attached and discouraged workers as a percentage of the labour force (11.0%) remain close to its peak of 11.5% in December 2009 and well above the 5% observed at the end of 2007. These trends along with the increasing skill mismatch between open positions and skills of applicants (August unemployment rate was 9.6% whereas 14.0% among high school or less) indicate that the US economy is probably facing a serious unemployment problem. On this regard and unless the economy experiences a positive structural change like in the 90s, we estimate that it could take much more than four years for the unemployment rate to drop around the pre-crisis levels.

Chart 5

**USA: Total Nonfarm Payroll and recessions (Index, T-12 months=100, T=start of recession)**

Source: BBVA Research

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## Economic Analysis

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## Calendar: Indicators

## USA: Industrial Production (August, September 15th)

<b>Forecast:</b> 0.4% m/m	<b>Consensus:</b> 0.2% m/m	<b>Previous:</b> 1.0% m/m
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**Comment:** Industrial production has been increasing since June 2009. However, regional manufacturing indices suggest that the pace of manufacturing activities at regional levels has been cooling down. ISM Manufacturing prints for August support this view. Although the index was still above 50, indicating a growth in manufacturing production, the pace has slowed down in the last couple of months. **Market impact:** A large negative surprise could renew market concerns over an abrupt halt.

## USA: Consumer Price Index, core (August, September 17th)

<b>Forecast:</b> 0.2%, 0.1% y/y	<b>Consensus:</b> 0.3%, 0.1% y/y	<b>Previous:</b> 0.3%, 0.1% y/y
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**Comment:** Consumer price index has been followed more closely due increased risk of a deflation. We expect both core and headline inflation would continue to increase moderately in August. The minutes combined with Bernanke's recent speeches in August imply that the Fed will remain in its wait-and-see mode in the near term before shifting its policy orientation and stands ready to act aggressively if conditions warrant. Therefore, we expect both inflation rates to remain stable and positive but low in the near term. **Market impact:** Although the probability of a deflation is low, a negative surprise would restart the discussion over deflation scenarios.

## Eurozone: IPI (July, September 13th)

<b>Forecast:</b> 0.6% m/m	<b>Consensus:</b> 0.3% m/m	<b>Previous:</b> -0.1% m/m
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**Comment:** We expect industrial output to have increased slightly in July, after being flat in the previous month, consistent with the improvement observed in both industrial orders in recent months (especially from abroad) and managers' confidence in July. Nonetheless, both indicators suggest that the upward trend is slowing. Overall, the strong recovery of industrial sector should be decelerating due to the weakness of both domestic and foreign demand. **Market Impact:** A significant negative surprise would raise market concerns over the path of expansion through H2.

## Eurozone: Exports (July, September 16th)

<b>Forecast:</b> 1.4% m/m	<b>Consensus:</b> n.a.	<b>Previous:</b> 5.2% m/m
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**Comment:** After strong growth in June, exports are expected to moderate markedly in July. They are already close to pre-crisis levels, recovering from a cumulative drop of around 25%. Expectations on foreign trade showed mixed signs from surveys by the EC (moderate increase) and PMI (moderate decline), but in both cases they suggest that exports growth are likely to moderate in coming months, in line with recent doubts over the US cycle and the moderation observed in some Asian economies. We see the cyclical peak in exports behind us. **Market Impact:** A negative surprise could have a relevant market impact by raising concerns over a sudden slowdown.

## China: Industrial Production (August, September 11th)

<b>Forecast:</b> 13.2% y/y	<b>Consensus:</b> 13.0% y/y	<b>Previous:</b> 13.4% y/y
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**Comment:** We expect a continued moderation in China's industrial production (IP), in line with the deceleration trend of the past four months (IP peaked at 18.1%/y/y in March). The moderation trend is in line with our soft-landing scenario as the authorities seek to restrain rapid credit growth and investment. IP will be released along with several new monthly indicators, including urban fixed asset investment, retail sales, and new loans. **Market Impact:** Following last month's upturn in PMI, a higher-than-expected IP outturn would help ease concerns.

## India: Wholesale Price Index (August, September 14th)

<b>Forecast:</b> 9.5% y/y	<b>Consensus:</b> 9.6% y/y	<b>Previous:</b> 10.0% y/y
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**Comment:** India will release its August whole sale price index (WPI) on September 14. Inflation in India has been among the highest in Asia, together with Vietnam, due to demand pressures from rapid economic growth and rising food prices. We expect inflation to decelerate in August due to a further decline in manufactured goods' prices and base effects from the previous year. **Market Impact:** A higher-than-expected reading may trigger even more aggressive interest rate hikes by the Reserve Bank of India.

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## Markets Data

			Close	Weekly change	Monthly change	Annual change
Interest Rates (changes in bps)	US	3-month Libor rate	0.29	0	-8	-1
		2-yr yield	0.58	7	4	-33
		10-yr yield	2.80	10	6	-55
	EMU	3-month Euribor rate	0.88	-1	-2	11
		2-yr yield	0.72	8	6	-48
		10-yr yield	2.38	3	-4	-85
Exchange Rates (changes in %)	Europe	Dollar-Euro	1.271	-1.3	-1.1	-12.8
		Pound-Euro	0.83	-1.0	0.2	-5.5
		Swiss Franc-Euro	1.30	-0.8	-3.6	-14.0
	America	Argentina (peso-dollar)	3.95	0.0	0.3	2.4
		Brazil (real-dollar)	1.72	-0.4	-2.9	-5.4
		Colombia (peso-dollar)	1801	-0.4	-0.7	-9.6
		Chile (peso-dollar)	495	-0.2	-2.7	-10.2
		Mexico (peso-dollar)	12.96	0.1	2.0	-3.1
		Peru (Nuevo sol-dollar)	2.79	-0.2	-0.5	-4.6
	Asia	Japan (Yen-Dollar)	84.23	-0.2	-2.0	-6.9
		Korea (KRW-Dollar)	1163.90	-0.7	-1.9	-4.7
		Australia (AUD-Dollar)	0.926	1.1	3.3	7.3
Comm. (chg %)	Brent oil (\$/b)		77.7	1.3	2.8	14.7
	Gold (\$/ounce)		1246.6	0.0	2.7	24.0
	Base metals		511.9	0.4	3.1	11.7
Stock Markets (changes in %)	Euro	Ibex 35	10706	1.0	3.5	-6.5
		EuroStoxx 50	2780	1.2	2.2	-1.8
	America	USA (S&P 500)	1109	0.4	2.4	6.4
		Argentina (Merval)	2435	0.5	2.9	28.2
		Brazil (Bovespa)	66714	0.1	1.1	14.3
		Colombia (IGBC)	14398	2.4	9.1	36.8
		Chile (IGPA)	22069	1.8	7.6	43.8
		Mexico (CPI)	32466	-0.4	1.3	10.2
		Peru (General Lima)	15850	1.8	7.0	9.2
		Venezuela (IBC)	65271	0.4	1.1	25.2
	Asia	Nikkei225	9239	1.4	0.3	-11.5
		HSI	21257	1.4	0.7	0.5
Credit (changes in bps)	Ind.	Itraxx Main	107	1	-7	21
		Itraxx Xover	482	2	-29	-81
	Sovereign risk	CDS Germany	40	4	-4	19
		CDS Portugal	327	29	55	273
		CDS Spain	234	12	20	168
		CDS USA	47	2	-1	---
		CDS Emerging	252	16	26	-50
		CDS Argentina	888	35	59	-568
		CDS Brazil	126	7	8	2
		CDS Colombia	131	8	11	-23
		CDS Chile	77	2	-6	1
		CDS Mexico	141	8	25	-16
		CDS Peru	126	18	18	-6

Source: Bloomberg, Datastream and JP Morgan

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