

Global

Weekly Watch

Madrid, 24 September 2010

Economic Analysis

Financial Scenarios

Sonsoles Castillo
s.castillo@grupobbva.com
+34 91 374 44 32

Marcos Dal Bianco
marcosjose.dal@grupobbva.com
+34 91 538 63 49

María Martínez Álvarez
maria.martinez.alvarez@grupobbva.com
+34 91 537 66 83

Ignacio González-Panizo
ignacio.gonzalez-panizo@grupobbva.com
+34 91 538 63 50

Victoria de Zuriarrain
victoria.zuriarrain@grupobbva.com
+34 91 537 75 84

Javier Amador
javier.amador@bbva.bancomer.com
+52 56 21 7718

Cristina Varela Donoso
cvarela@grupobbva.com
+34 91 537 7825

The Fed is ready for QE2...

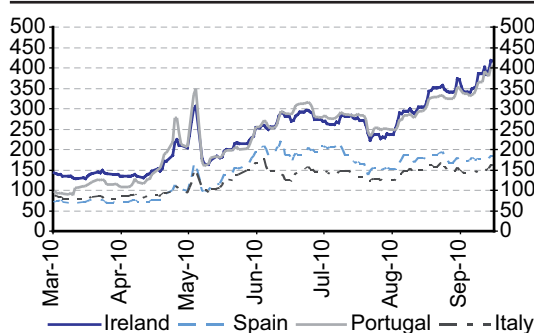
The main question prior to the FOMC's policy statement on Tuesday was how far they would lean in the direction of additional quantitative easing (QE2). The tone of the statement went further than expected: The key change was the shift in focus from the economic recovery to the risks of deflation –the FOMC acknowledged that current inflation levels are “somewhat below” those consistent with its mandate. The policy paragraph sent an explicit signal that QE2 is under consideration: the Fed is “prepared to provide additional accommodation if needed to support the economic recovery and to return inflation, over time, to levels consistent with its mandate.” A decision is likely to be made in the next meeting to be held in November. By shifting the focus to the risks of deflation it seems that it takes economic strength in the near future (unlikely) to stop them from QE2 rather than needing new weakness as was the case before the substantive changes in the policy statement. This week's US housing sector data –somewhat better than expected– calmed fears, but jobless claims unexpectedly rose, underscoring the weakness in the labor market.

... in Europe sovereign risk remains high

Europe has been a matter of concern this week as investors are still perceiving a high sovereign risk. Concerns focus on the Irish banking system and the doubts on whether Portugal would be able to accomplish its deficit cut plan. Worries were clearly reflected on the higher yields investors demanded at this week's debt auctions. Regarding macro, this month's PMI indicators sharp drop was larger than expected after the surprising increase in July and a slight fall in August, and adds more evidence to a further deceleration in the Euro zone economy, in line with our projections.

Chart 1

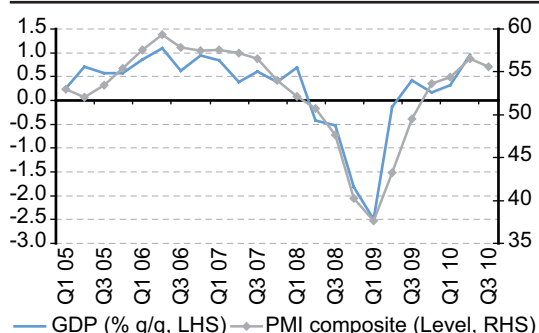
10yr bond spreads against Germany (bps)



Source: Bloomberg

Chart 2

Eurozone: GDP growth and expectations



Source: Markit Economics and Eurostat

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Some tools could prevent appreciation pressures on Latam currencies

Dollar weakness has put pressure in Fx crosses. In Latam, government measures could moderate the effect.

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Europe's repo market is resurgent

The European repo market has improved significantly, since December 2009 it has increased 25% up to € 6,979 bn in June 2010. This pick up in repo activity is led by those strongest banks who are borrowing more through the repo market, while weaker banks still rely on ECB funding.

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Capital flows to emerging markets continue

Flows into emerging markets have evolved strong since the beginning of the year, both in equities and bonds, despite the recent negative surprises in developed areas, driven by those investors seeking higher returns given not only the low rates in core countries but also the good perspectives in emerging markets.

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Nicolás Trillonicolas.trillo@grupobbva.com
+34 91 537 84 95*Exchange Rates Europe*

Chief Strategist

Pablo Zaragozapzaragoza@grupobbva.com
+34 91 374 38 64*Financials***David Golin**david.golin@grupobbva.com
+34 91 537 87 46

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Markets move to the tune of central banks and peripheral economies

Central banks' determination to prevent any sign which might hint towards a recession will continue to keep long-term rates low, as will the absence of inflationist pressure (not only for this year, but for forthcoming years too) and low real rates (a sign that risk aversion will remain an issue, especially as far as the economy, peripherals and Banks are concerned).

Currencies are also still highly exposed to the decisions made by the respective monetary authorities. A clear example being the dollar's depreciation of over 2% vs. other main currencies, as is reflected by the effective exchange rate. The euro appreciated to the same degree.

Meanwhile, equity markets continue to trade an idiosyncratic risk scenario in which Ireland's and Portugal's problems will remain confined to these two economies. This will allow them to continue consolidating and trading rangebound, regardless of other supports such as: i) share buyback announcements; ii) the spread vs. risk-free assets which can be seen through the dividend; and iii) M&A activity.

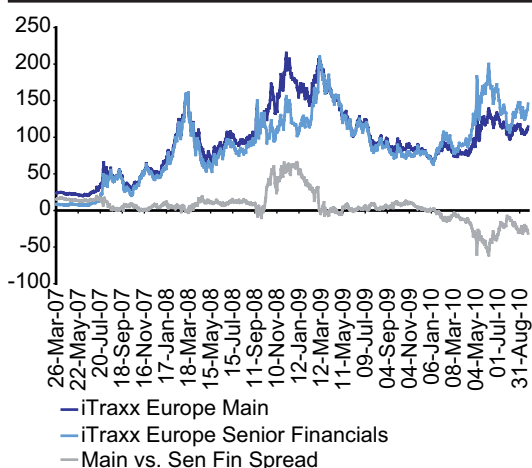
Interest rates to remain low

Expectations of extensions of the monetary stimuli put in place by OECD central banks should continue to bolster our outlook of caps on any attempts at rises in rates. The latest FOMC meeting has reinforced dovish arguments for interest rate curves, not only for the US, but also other regions (Britain and the Eurozone), which until now had more of an upward bias. In fact, this trend may even affect the short end of curves (this is significant in the Eurozone, and should therefore bring an end to the upward trend of recent weeks).

Credit: uncertainty about Ireland and its banking system

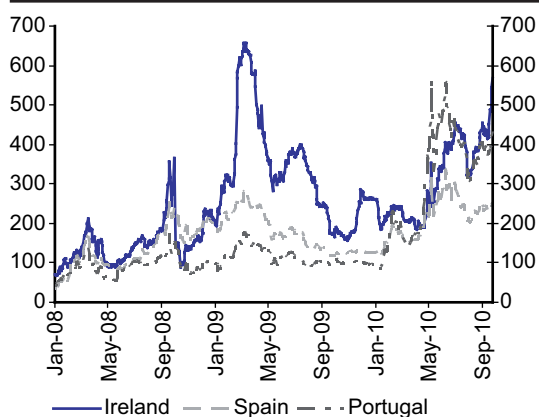
The credit markets and especially financials have been under a renewed stress, particularly due to a possible default by Anglo Irish Bank. This has caused significant volatility in both European peripheral sovereign countries and Banks (Portuguese Banks mainly). Meanwhile, the primary market remained fairly strong in terms of volume of issuance, but behaviour in the secondary market has not been consistent across the board, with some issues widening since the launch. Finally, following announcement of less stringent Basel III capital requirements, and after strong initial performance, Tier 1 has underperformed over the last week across the capital structures of all European financials, losing some of its gains.

Chart 3

iTraxx Main vs Senior Financial

Source: Bloomberg and BBVA Research

Chart 4

CDS 5 yrs financials (senior debt in bps)

Source: Datastream and BBVA Research

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Maria Martínez Álvarez
maria.martinez.alvarez@grupobbva.com
+34 91 537 66 83

Cristina Varela Donoso
cvarela@grupobbva.com
+34 91 537 7825

Some tools could prevent appreciations pressures on Latam currencies

Despite the fact that OCDE currencies could suffer some risk of appreciation, after the FOMC's statement, most of Latin American currencies could maintain relative stability. In our opinion, this could happen on the back of domestic measures that curbs the appreciation movements. Recently comments by some Latin American authorities indicate a certain intervention risk. In this regard, Brazilian government announces SWF will buy dollar with the intention of moderating appreciation pressures. In the same line, Colombian authorities have been forced to resume its dollar purchase program. Moreover, Peru government has been forced to step up non traditional measures: increase in reserve coefficient and further loosening on restriction to AFP foreign asset purchases. Also, there is some risk of Chilean peso intervention following the movements by its neighbours mentioned above, even though comments from Chilean president point at the country feels comfortable with the current CLP levels. Summing up, Latin American authorities resist appreciation pressures with hints of increased bias towards intervention.

Europe's repo market is resurgent

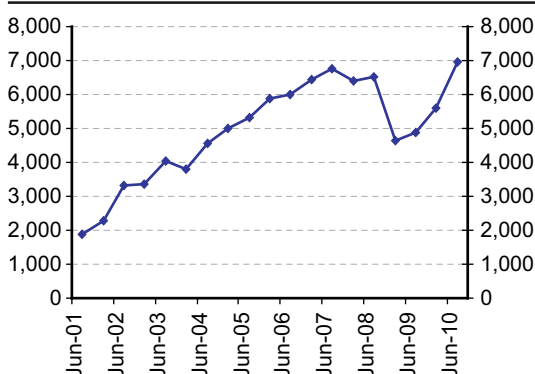
The European repo market has improved significantly according to European Repo Market Survey published by ICMA last week. Since december 2009 it has increased 25% up to € 6,979 bn in June 2010 confirming an ongoing recovery. This figure is above the previous (and highest) amount € 6,775 bn, recorded in June 2007 before the financial crisis. This pick up in repo activity is led by those strongest banks who are borrowing more through the repo market, while weaker banks still rely on ECB funding. It is also remarkable the fact that a significant number of operations are registered and cleared across Central Clearing Counterparts which allows reducing counterparty risk. Thus, the cost of borrowing using these platforms is less than 1% which institutions pay the ECB and below the Euribor 1-month, however not all institutions have access to these platforms. Regarding Spain, early August LCH-Clearnet (the largest clearer of repos in Europe) decided to accept Spanish government bonds as collateral for REPOS, and in August Spanish repo service cleared €130 billion (Spanish banks have around ¼ of Spanish bonds).

This survey refers to data up to 9 June 2010, not providing therefore information about the development of the funding markets after the maturity 12m LTRO. We consider that this event joined to the extent that financial risks have eased since June will yield an increase in volumes traded through the repo market in the near future. Against this background, taking into account European banks return to markets and the improving in repo activity, we think that such institutions will rely less on the ECB funding in the coming months.

Capital flows to emerging markets continue

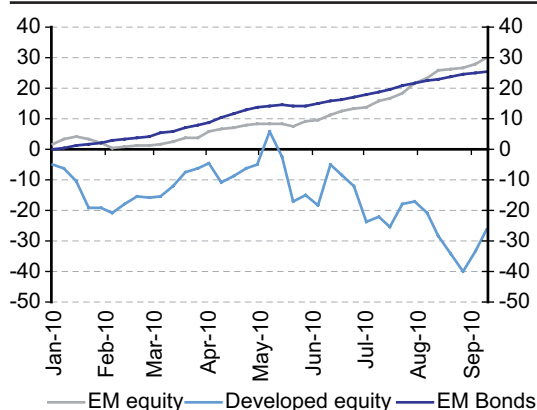
Flows into emerging markets have evolved strong since the beginning of the year, both in equities and bonds, despite the recent negative surprises in developed areas. By contrast, flows into developed markets have been fallen strongly since May. This trend is driven by those investors seeking higher returns given not only the low rates in core countries but also the good perspectives in emerging markets, what may have motivated investors opting to invest in such markets. According to developments occurred so far this year, if medium and large economies growth (albeit at a slower pace) continues and concerns about sovereign debt relax (and, of course, maintaining the macroeconomic stability in emerging countries) we forecast slight risk in this trend to be reversed along the year.

Chart 5

Total repo business (eur bn)

Source: ICMA

Chart 6

Net inflows in equity and bonds (accumulated in \$ bn)

Source: EPFR

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Europe
Elvira Prades
elvira.prades@grupobbva.com
(+34) 91 537 79 36

Agustín García Serrador
agustin.garcia@grupobbva.com
+34 91 374 79 38

US
Hakan Danis
hakan.danis@bbvacompass.com
+1 713 843 5382

Mexico
Julian Cubero
juan.cubero@bbva.bancomer.com
(+52) 5556214143

Asia
Bingje Hu
bingje.hu@bbva.com.hk
(+852) 2582 3117

Fielding Chen
fielding.chen@bbva.com.hk
+852 2582 3297

Calendar: Indicators

Eurozone: Flash estimate inflation (September, September 30th)

Forecast: 1.8% y/y	Consensus: 1.8% y/y	Previous: 1.6% y/y
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Comment: Although inflation slowed in August, we forecast a slight rebound in September due to higher energy inflation, as a consequence of the base effect as well as higher oil prices and a slight depreciation of euro. The flash estimate does not provide information about core inflation, but we also expect it to increase by 0.1pp to 1.1% y/y driven by an acceleration in both services and non-energy industrial goods inflation. We continue to see some upside risks resulting from both the impact of tax hikes and significant industrial inflation on consumer prices, as well as some strains in food market. **Market Impact:** A negative surprise could be seen as a sign of weakness in households' spending, but a positive surprise could raise fears of earlier than expected rate rises by the ECB, after positive growth figures.

Eurozone: Unemployment rate (August, October 1st)

Forecast: 10%	Consensus: 10%	Previous: 10%
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Comment: Unemployment is thought to have remained broadly stable in August, supported by the rebound of economic activity. In addition, hiring intentions from the EC survey declined slightly in August, interrupting the upwards trend observed since end-2009, while consumer's unemployment expectations declined further. However, the trend of unemployment will be to increase slightly in coming months, in line with a scenario of a weaker activity. **Market Impact:** A negative surprise would be interpreted as a sign of renewed downward pressures in economic activity, with negative effects on economic confidence.

US: Consumer Confidence (September, Tuesday 10:00 ET)

Forecast: 53.5	Consensus: 54.0	Previous: 53.5
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Comment: Consumer confidence has been subdued since the start of the financial crisis. The index decreased from 111.2 in February 2007 to its historical low of 25.3 in February 2009. The index is currently at 53.5 which is still significantly lower than its historical average due to high unemployment, weak labor market and high uncertainty in business conditions. We expect consumer confidence to remain flat in September. **Market impact:** A significant increase in consumer confidence would be a good surprise for the market and help dispel some of the pessimism in the market.

US: GDP (2Q10 Final, Thursday 08:30 ET)

Forecast: 1.6%	Consensus: 1.6%	Previous: 1.6%
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Comment: Bureau of Economic Analysis (BEA) will release its final estimate of GDP for 2Q10. BEA had estimated 1.6% annualized growth for 2Q10 and we expect no further revision. Based on the latest data, in 2Q10, PCE increased by 2.0% which is the highest growth rate since 1Q07. However, we keep our baseline scenario of low PCE growth due to ongoing household deleveraging process, increased uncertainty in the economy and high unemployment rates. The market will be waiting for the BEA's preliminary estimate for 3Q10 which will be released on October 29. **Market impact:** Although we do not expect any new surprises, any significant downward revision would increase doubts over sustainability of economic recovery and incite double-dip fears.

Mexico: July's IGAE, (monthly economic indicator)

Forecast: -0.2 m/m sa	Consensus: na	Previous: -0.4%
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Comment: The Mexican "monthly GDP" will point to a slower growth phase at the beginning of 3Q10 after the peak registered in the previous quarter. **Market impact:** an incoming phase of more moderated growth due to weaker US demand is the scenario that the market is considering. Tentatively, a very negative surprise on IGAE's could weight on markets perception of the rhythm of the deceleration of the Mexican economy and its resilience to US lower growth.

China: PMI (Oct 1st)

Forecast: 53.5	Consensus: 52.8	Previous: 51.7
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Comment: Growth momentum has re-gained some strength in the past month as indicated by last month's PMI reading, and more recent data in August on industrial production, retail sales, and imports. In line with these stronger-than-expected indicators, and usual seasonality trends, we expect another strong PMI reading for September. **Market impact:** With observers now more relaxed about prospects of a soft-landing for China's economy, a significantly weaker PMI reading could put markets on edge, while a stronger reading might intensify expectations of interest rate hikes or other forms of monetary tightening.

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			Close	Weekly change	Monthly change	Annual change
Interest Rates (changes in bps)	US	3-month Libor rate	0.29	0	-1	1
		2-yr yield	0.43	-3	-8	-55
		10-yr yield	2.59	-14	12	-72
	EMU	3-month Euribor rate	0.88	0	-1	14
		2-yr yield	0.72	-6	11	-50
		10-yr yield	2.32	-10	17	-93
Exchange Rates (changes in %)	Europe	Dollar-Euro	1.346	3.2	6.0	-8.3
		Pound-Euro	0.85	2.1	4.3	-7.3
		Swiss Franc-Euro	1.32	0.1	1.3	-12.6
	America	Argentina (peso-dollar)	3.95	0.2	0.2	2.9
		Brazil (real-dollar)	1.71	-0.1	-2.6	-5.1
		Colombia (peso-dollar)	1814	0.6	0.1	-5.8
		Chile (peso-dollar)	486	-2.5	-3.6	-10.9
		Mexico (peso-dollar)	12.54	-1.8	-3.5	-7.5
		Peru (Nuevo sol-dollar)	2.79	-0.1	-0.3	-3.3
	Asia	Japan (Yen-Dollar)	84.25	-1.8	-0.5	-6.2
		Korea (KRW-Dollar)	1150.30	-0.9	-3.6	-3.4
		Australia (AUD-Dollar)	0.960	2.3	8.1	10.9
Comm. (chg %)		Brent oil (\$/b)	78.7	0.6	4.9	20.8
		Gold (\$/ounce)	1297.1	1.8	4.8	30.9
		Base metals	522.6	0.4	4.3	21.6
Stock Markets (changes in %)	Euro	Ibex 35	10703	1.1	7.0	-8.1
		EuroStoxx 50	2783	0.9	6.8	-1.7
	America	USA (S&P 500)	1142	1.5	9.1	9.4
		Argentina (Merval)	2523	2.0	8.7	25.1
		Brazil (Bovespa)	69259	3.2	8.4	14.8
		Colombia (IGBC)	14064	0.1	2.7	26.9
		Chile (IGPA)	22258	-1.1	6.4	42.5
		Mexico (CPI)	33369	1.0	6.9	16.0
		Peru (General Lima)	17202	2.9	14.9	13.9
		Venezuela (IBC)	65932	1.1	1.8	27.2
	Asia	Nikkei225	9472	-1.6	6.3	-7.7
		HSI	22119	0.7	7.3	5.2
Credit (changes in bps)	Ind.	Itraxx Main	117	10	-1	30
		Itraxx Xover	529	58	6	-48
	Sovereign risk	CDS Germany	40	-1	-4	18
		CDS Portugal	396	32	67	345
		CDS Spain	229	-6	-15	163
		CDS USA	49	2	2	---
		CDS Emerging	236	-5	-21	-39
		CDS Argentina	770	1	-167	-352
		CDS Brazil	120	3	-8	-13
		CDS Colombia	127	1	-7	-33
		CDS Chile	77	2	-6	1
		CDS Mexico	134	6	0	-30
		CDS Peru	122	-9	7	-19

Source: Bloomberg and Datastream

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