BBVA Research

Global

Weekly Watch

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Economic Analysis

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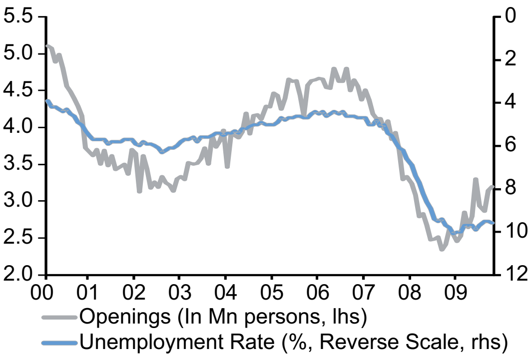
BOJ increased its quantitative easing…

This week has been marked by decisions of the central banks of developed countries, and statements by Fed members preparing the ground for a QE2 at the next meeting in November. The surprise came from Japan, which has announced the purchase of $59.7 billion worth of assets and the reduction of the reference rate. While the Bank of England maintained previous levels of interest rates and of the asset purchase program, the ECB, although failing to provide developments in relation to the average liquidity, showed a tone of dissatisfaction with the movements in exchange rates, with the euro testing the 1.40 level against the dollar and accumulating a strong real appreciation in the last month. It is clear that the meetings in Washington this weekend will be marked by the debate on foreign currency. And here the pressure to allow emerging currencies to reflect their fundamentals will also be important.

…FED will do in November

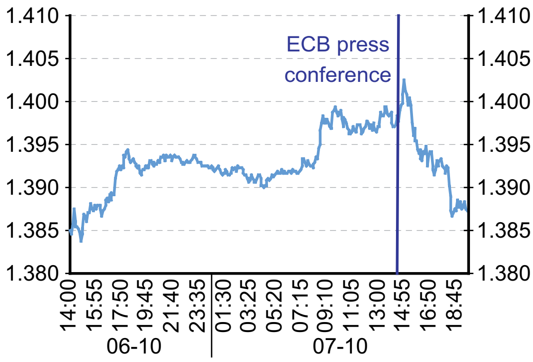
Next week we will have more clues on the possible decision by the Fed. On the 12th, the minutes of the September FOMC meeting will be published, and on the 15th, Bernanke will speak at the Chicago Fed. Although the data we have observed this week in US, such as: Pending Home Sales, ISM non-manufacturing, among others, have fared better than expected, it is not enough to eliminate the current slowing trend. Additionaly the payrolls figure released today does not change our overall assessment of weak labour market conditions and a slow recovery going forward. While there are some positive signs, the report, which is the last employment report before the next FOMC meeting will not modify the Fed view that further stimulus may be needed. In our opinion, in November the Fed will decide to go ahead with a gradual QE2, giving flexibility to modulate asset purchases.

Chart 1
Job Openings and Unemployment



Source: BLS and BBVA Research

Chart 2
Euro-Dollar: intraday change ($/€, Price each 5 minutes)



Source: Bloomberg and BBVA Research

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Impact of an increase in the euro on Euro zone GDP

The euro quick movement has raised some question about its impact on Eurozone growth. In a theoretical exercise the greatest impact is experienced in the second year

The European Financial Stability Facility

EFSF guarantees commitments of up to €440 billion, but credit enhancements limit the amount to led

Emerging markets ready to step up efforts in the currency war

Quantitative easing in the US could clearly accelerate flows to emerging markets requiring them to step up their efforts in the “currency war”

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Impact of "QE2" on the different assets

The imminent implementation of quantitative easing measures in the US has direct consequences for: i) interest rates (greater room for falls, especially in the US), ii) exchange rates (greater room for global depreciation of the dollar, and appreciation of the euro), iii) credit (investors looking for more attractive yields, mainly among corporates), and iv) equity (more firmly supported by the increase in global liquidity). These trends could be in place while uncertainties about the intensity, duration and way of implementation of the "QE2" remain.

Room for lower yields and for continuation of recent currency movements

The possibility of an additional flow of purchases may mean that the lows seen during the summer (2.40% in 10Y Treasury) will not act as a floor, and that we could see additional downward movements. In any case, any move should not be too aggressive, since this scenario is already largely priced in by the market. The impact on euro rates should not be immaterial, but ought to be more limited due to the more unbending attitude shown by the ECB.

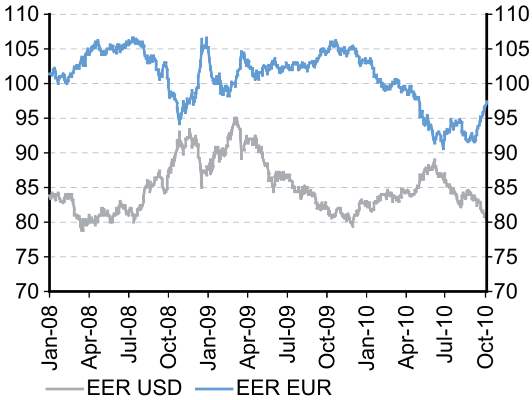
In currencies, the possibility of a continuation of the dollar's global depreciation still remains. The fact that similar actions by the ECB are remote could continue to support a euro appreciation against the dollar and also at a global level. Finally, this movement is particularly applicable to crosses with emerging currencies, since any measures aimed at slowing these currencies' appreciation vs. the dollar remains relatively ineffective.

Equity: performance determined by currencies and corporate earnings

Although it may not seem so, the S&P 500 is not performing that well. It appears to be doing well, having broken above the resistance at 1,150 points that we have been talking about for several weeks, reaffirming our positive outlook for equity markets for the remainder of the year. Even so, we would highlight that US equities are increasingly helped by the depreciation of the USD. In fact, if we look at equity market's earnings in euros since 1 September, when the dollar started to fall sharply vs. most other currencies, the US index has dropped by -1.3%, while the EuroStoxx 50 has risen by 2.4% and the Ibex 35 1.5%.

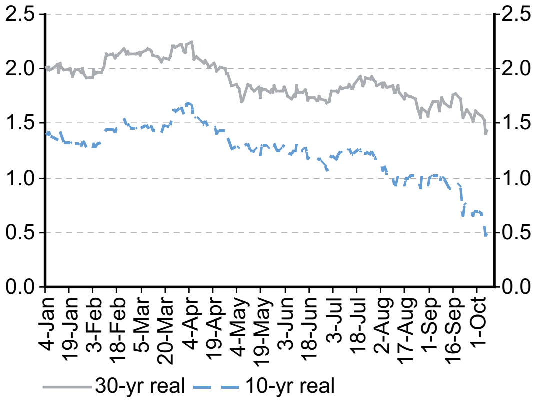
Looking further ahead, beyond this passing movement, the current currency "war" may have unforeseen consequences in 2011 for equities. European companies exposure to non-euro countries is around 35%, so applying a rule of thumb we can make an educated guess of an impact of -3.5% on the initial forecast of +11.7% for every 10% that the euro appreciates.

Chart 3
EUR vs USD: Effective Exchange Rate (EER)



Source: Bloomberg

Chart 4
US: Real Rates (10- and 30-yr Bonds)



Source: Bloomberg

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Highlights

Impact of an increase in the euro on Euro zone GDP

Since mid-September the euro has been supporting appreciation pressure against major currencies. Accordingly, the euro real effective exchange rate has increased by 6% in just one month. This movement has raised some concern about its impact on European growth, especially if this trend is consolidated. According to our estimation, an increase of the euro effective exchange of 5% will decrease 0.2% of Eurozone GDP over the next 12 months and by 0.5% in the second year. In any case, this remains a mere theoretical exercise but give us an idea of the eventual impact of a sustained euro appreciation. This impact could be considered a minimum, especially when considering additional factors, such as higher volatility or disorderly movements commented by ECB´s Governor in the recent press conference, and non-linear effects.

The European Financial Stability Facility

The European Financial Stability Facility (EFSF) provides temporary financial assistance to euro area countries in difficulty. In order to reach its objective the EFSF can issue bonds or other debt instruments on the market to raise the funds needed to provide loans to those countries. These issues would be backed by guarantee commitments given by euro area Member States up to €440 billion. The total guarantee amount could vary depending on several factors (i.e. one of the Guarantors makes a demand for a stability support loan from the EFSF or, eventually, in the case of a downgraded country rate). This implies that if out of the total of the guarantees we subtract those of Greece and those of the two countries at risk to seek help, the total of guarantees would be reduced to €409, 500 million. The EFSF has a triple A rating achieved through credit enhancements: an over guarantee of 120%, an up front cash reserve and a loan specific cash buffer. But in order to maintain a triple A rating the amount lent out could be equal to 120% of the available triple A guarantees. Then the amount to be lent will be reduced to €255bn. Additional a cash buffer must be subtracted from this amount. EFSF bonds are expected to be eligible as collateral to the ECB. The lending could be structured by the following elements: a) Service Fee 50 basis points of the principal amount; b) Net Present Value of the margin: 300 basis points for loans up to 3 years plus another 100 basis points per additional year; c) a specific cash buffer. These 3 elements would be deducted from the cash amount remitted to the Borrower but would not reduce the principal amount of that loan. Over the principal amount would be charged a low interest rate because of the aforementioned guarantees. In any case, according to the EFSF words, there are more factors that could make variations over the current system agree among all the actors.

Emerging markets ready to step up efforts in the currency war

Quantitative easing in the US could clearly accelerate flows to emerging markets requiring them to step up their efforts in the “currency war”. Brazil confirmed its aggressive stance of this subject this week, with an increase in its financial transaction tax and a loosening of restrictions on USD purchases. Going forward, countries have a menu of options. The first line of defense is simply increasing foreign currency purchases, but this may be difficult in countries that already have limited room for sterilization. Capital controls or brakes (via taxation) are accordingly being increasingly considered. Moreover, in some countries that are already experiencing strong credit growth, authorities may also introduce macroprudential restrictions on lending, not specifically targeted to foreign investors. In Latin America, Chile and Colombia might target increased intervention at this stage, while Brazil and Peru are closer to (further) capital controls and probably additional macroprudential policies (like hiking reserve coefficients). In Asia, sentiment is tilted towards maintaining open capital accounts at this stage, so immediate measures are not expected. As to the likelihood of the success of these measures, previous experience shows that partial controls can be successful in the short-term, but their impact vanishes over time. Accordingly, if the liquidity injection in developed economies is large and protracted, it may prove very difficult to control its impact on the emerging markets.

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Calendar: Indicators

Eurozone: IPI (August, October 13rd)

Forecast: 0.3% m/m	**Consensus:** 0.7% m/m	**Previous:** 0.1% m/m

Comment: We expect it to have increased slightly in August. Industrial managers' confidence showed mixed signs from surveys by the EC (deceleration in the pace of improvement) and PMI (moderate decline), but in both cases industrial orders from abroad fell. Overall, industrial production in these two months of Q3 should have continued to increase over Q2, around 0.5%, thus confirming the slowdown in the pace of industrial recovery after growing around 2.5% q/q in previous quarters. **Market Impact:** A negative surprise could have a relevant market impact by raising concerns about a sudden slowdown.

Eurozone: Exports (August, October 15th)

Forecast: -1.3% m/m	**Consensus:** n.d.	**Previous:** -0.6% m/m

Comment: We expect Eurozone exports to have fallen further in August, after declining slightly in July, as exports orders also dropped in recent months. In addition, expectations on foreign trade from surveys suggest that exports growth is likely to moderate or to fall slightly in coming months, in line with doubts about the US recovery and some slowing in economic growth in Asia. Overall, July-August exports level should still be around 3% above Q2 level, above pre-crisis figures. On the other hand, imports also fell in July, more than exports, and they are likely to be subdued due to private consumption weakness and the depletion of both rebuilding inventories process and industrial recovery. **Market Impact:** A negative surprise could have a relevant market impact by raising concerns about the main driver of the recovery.

FOMC Minutes (Sept-21, Tuesday 14:00 ET)

Comment: The FOMC statement on Sep. 21 indicated significant changes in the Fed's economic outlook. The Fed acknowledged slower-than-expected growth and higher deflationary risks and left the door open for a second round of quantitative easing (QE2). Therefore, the minutes will help understand the details of the meeting and forecast any possible policy changes which might take place in the Fed's next meeting on November 2-3. **Market impact:** The last statement and recent speeches by regional Fed presidents and Fed governors indicate that the Fed is getting ready for QE2 in November. Any clear hints for a policy change will have an impact in the market.

CPI, core (September, Friday 08:30 ET)

Forecast: 0.2%, 0.1%	**Consensus:** 0.2%, 0.1%	**Previous:** 0.3%, 0.1%

Comment: Consumer prices are expected to remain low in line with our baseline. In the previous month, headline CPI increased by 0.3% on a seasonally adjusted basis (1.2% YoY). The main driver of headline inflation in August was the energy prices which increased 2.3%. We expect that headline and core inflation will increase slightly by 0.2% and 0.1% in September, respectively. Our forecast implies that 12-month core inflation will remain stable at 0.9% for the past six months. **Market impact:** A decrease in consumer prices would have a negative impact on the market and increase the probability of a deflation and therefore, QE2.

China Property Prices (September, October 11-15)

Forecast: 9.3 y/y	**Consensus:** 8.8 y/y	**Previous:** 9.3 y/y

Comment: Property prices have been moderating in year-on-year terms for the past four months following April's peak of 12.8% y/y, and have been flat in m/m terms. Prices may have held up in September, despite earlier administrative measures to prevent price bubbles, on signs that activity in the sector has picked up. The government intensified tightening measures at the end of September to reduce mortgage lending. **Market impact:** A higher-than-expected reading could trigger market worries of further tightening measures, including interest rate increases, all the more so given recent higher-than-expected readings on PMI and other activity indicators.

Chile and Mexico: Monetary Policy Decision (14 and 15 October)

Forecast: Chi: 2.75%; Mex: 4.5%	**Consensus:** Chi: 2.75%; Mex: 4.5%	**Previous:** Chi: 2.5% ; Mex: 4.5%

Comment: Chile: Due to the recent appreciation of the peso, we expect the Central Bank to reduce the rate of normalization of monetary policy from 50 to 25 basis points at its next meeting. An increase of 50 points would surprise the market and determine a greater appreciation of the peso. Mexico: Activity and inflation are consistent with a longer monetary pause, even more than currently discounted by markets and analysts, who put the first rise in late summer 2011. **Market Impact:** appreciation pressures over LatAm currencies are producing different kinds of interventions, from higher fees and USD purchases to "wording"; then, the market will pay particular attention to any mention –or lack of it- on Peso exchange rate.

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				Close	Weekly change	Monthly change	Annual change
Interest Rates	(changes in bps)	US	3-month Libor rate	0.29	0	0	0
			2-yr yield	0.34	-7	-22	-62
			10-yr yield	2.36	-15	-40	-102
		EMU	3-month Euribor rate	0.97	3	9	23
			2-yr yield	0.81	-4	11	-56
			10-yr yield	2.28	0	-5	-92
Exchange Rates	(changes in %)	Europe	Dollar-Euro	1.392	1.3	9.6	-5.3
			Pound-Euro	0.87	0.6	6.2	-5.7
			Swiss Franc-Euro	1.34	-0.2	3.8	-11.8
		America	Argentina (peso-dollar)	3.96	-0.1	0.3	3.3
			Brazil (real-dollar)	1.68	0.0	-2.4	-3.3
			Colombia (peso-dollar)	1787	-0.5	-1.0	-3.7
			Chile (peso-dollar)	484	0.7	-2.3	-12.7
			Mexico (peso-dollar)	12.52	-0.4	-4.0	-5.8
			Peru (Nuevo sol-dollar)	2.79	0.0	-0.1	-2.6
		Asia	Japan (Yen-Dollar)	81.88	-1.8	-2.3	-8.8
			Korea (KRW-Dollar)	1118.13	-0.7	-4.0	-4.4
			Australia (AUD-Dollar)	0.981	1.1	6.2	8.6
Comm.	(chg %)		Brent oil ($/b)	83.1	-0.8	7.3	18.7
			Gold ($/ounce)	1340.3	1.6	7.8	27.7
			Base metals	531.9	0.5	3.9	23.7
Stock Markets	(changes in %)	Euro	Ibex 35	10674	2.1	-0.4	-9.1
			EuroStoxx 50	2777	1.6	-0.2	-3.7
		America	USA (S&P 500)	1160	1.2	5.1	8.3
			Argentina (Merval)	2641	-0.4	8.7	21.8
			Brazil (Bovespa)	70064	-0.2	5.2	9.4
			Colombia (IGBC)	15060	2.5	4.8	34.7
			Chile (IGPA)	22006	-1.7	-0.1	35.6
			Mexico (CPI)	34258	1.3	5.3	14.0
			Peru (General Lima)	18855	3.8	19.1	21.9
			Venezuela (IBC)	66325	-0.4	1.6	27.4
		Asia	Nikkei225	9589	2.0	5.4	-4.3
			HSI	22944	2.6	8.4	6.7
Credit	(changes in bps)	Ind.	Itraxx Main	103	-5	-3	13
			Itraxx Xover	476	-28	-6	-94
		Sovereign risk	CDS Germany	38	0	-2	18
			CDS Portugal	403	5	75	352
			CDS Spain	228	1	-6	161
			CDS USA	46	1	-1	---
			CDS Emerging	202	-18	-50	-49
			CDS Argentina	720	-19	-168	-242
			CDS Brazil	104	-9	-22	-10
			CDS Colombia	104	-10	-27	-37
			CDS Chile	77	2	-6	1
			CDS Mexico	109	-9	-32	-35
			CDS Peru	108	-9	-18	-14

Source: Bloomberg and Datastream

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