

Global

Weekly Watch

Madrid, 29 October 2010

Economic Analysis

Financial Scenarios
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Gradual approach to QE2

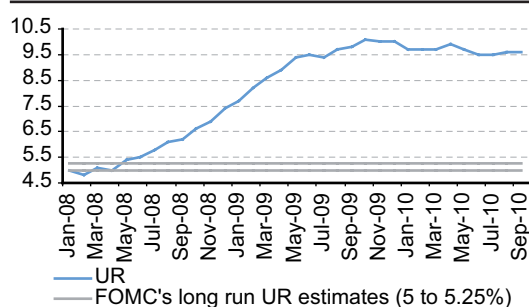
Over the past few weeks US economic data has been validating that a double-dip is not the most probable scenario. Albeit at low levels, the housing sector seems to be stabilizing, and more importantly 3Q GDP grew at a slightly faster pace than in 2Q. Yet, unemployment will likely remain at 9.6% which is too high for the Fed. Thus, the FOMC will most likely announce renewed monetary easing in its policy meeting next week. The key question is what approach to quantitative easing will the Fed take. Given the uncertainty around the impact of QE2 –the Fed reportedly surveyed market participants this week– and the strong internal debate within the FOMC, we anticipate that with QE2 the Fed will proceed with some caution –implementation will be gradual– and will advance on a more adjustable basis. Committing to a total purchase target is risky –it could fall short of market expectations– and thus, a more flexible option is to announce an initial amount –large enough to displace investment to other assets– packaged in terms of a comparable monthly sum. Enhanced policy guidance in the wording of the statement –a reference that the Fed will keep rates even longer than implied by extended period– can not be discarded as it would probably reinforce the effects of QE2. More interesting would be if they are ready and willing to announce additional unconventional measures.

... while the ECB will remain cautious

This week, liquidity funding by the ECB increased above expectations and was requested by more institutions, which reflects the fact that the market is still far from normalizing. Therefore, the ECB stance will remain cautious. In the Q&A the ECB could address that going forward it might consider other options such as an extension of the full allotment beyond the 1Q11. After the strong growth in 3Q10 the BoE is unlikely to introduce a new round of QE at next week's meeting. Lastly, the decision by the BoJ to include "BBB" rated bonds in its new leg of QE (¥5 trillion) reflects its objective to reduce long-term interest rates and risk premiums as well.

Chart 1

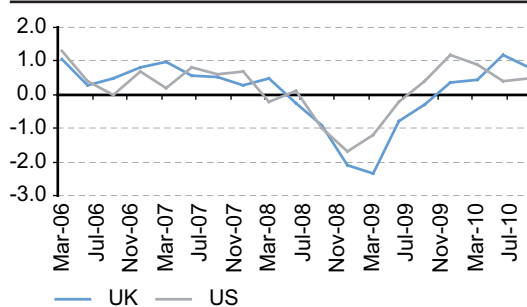
US Unemployment Rate (%)



Source: Bloomberg, Fed and BBVA Research

Chart 2

GDP Growth (QoQ % ch)



Source: Bloomberg and BBVA Research

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Strong growth in the German economy

Recent economic data suggest that German recovery is ongoing in the second half of the year. But domestic demand must continue to improve in order to sustain current growth.

Today's high US unemployment rates as a result of the business cycle

However, high unemployment rates lead to long-term unemployment if not corrected quickly. This supports the efforts of the Federal Reserve to correct the cycle.

Fiscal consolidation in European Peripherals still a point of concern

Our view is that strong government commitment and good fiscal performance in Spain may deter an increase in systemic risk premium.

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Waiting for details from the Fed

The market has priced in a lower probability of QE2 through rises in rates in the US and UK and appreciation of their respective currencies. As a result, there has not been such a clear downward trend in the market, given the slight positive momentum of some European macro data and on the whole some fairly solid company results in the USA and Europe.

New rise in risk premiums on the weakest sovereigns

European CDS' performance has been very varied, with major differences between the weakest countries in the Eurozone (Ireland, Portugal and Greece) and other European countries; Ireland's 5-year CDS has widened 45bps so far this week as a result of the deterioration in its financial system, the Greek CDS widened 84bps due to lingering concerns over its deficit reduction plans, and Portugal's CDS widened 23bps fundamentally due to the opposition party's refusal to approve the state budget. The primary market remains out of reach for these countries, while others such as Spain and Italy have shown some activity on the primary market through issues of covered bonds and senior debt. This demonstrates that Spanish entities are able to access the market using instruments other than covered bonds or GGBs.

In our opinion, the room on the upside in rates is limited...

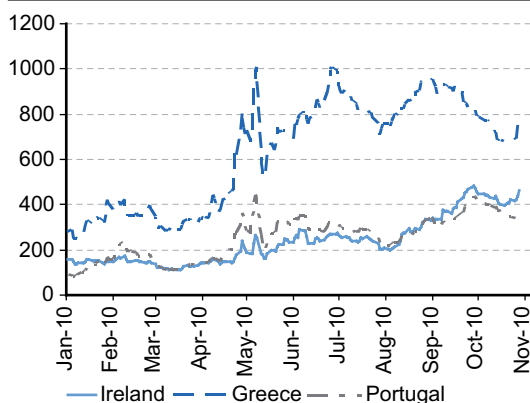
If eventually the package announced is in line with what we expect (a billion dollars), the rebounds in rates should be limited (2.80% for the 10Y USA). This outlook could even be transferred to Europe, where the rally in rates is still in full swing, supported by both the strength of the data and the "permissiveness" of the ECB. In this case, the upward bias in rates may be particularly counterproductive as it coincides with a period of further tightening of core-periphery spreads. Rather than widening of these spreads, the main risk may lie in the levels that rates could reach in these countries. Due to both funding risk and the impact that this may have in terms of a return to flows to safe haven assets (German bonds) core rates should start to find reasons to moderate.

... as is the scope for depreciation in the euro which has already returned to levels of 1.39 vs. the dollar

The movement which took the euro to 1.37 vs. the USD on the "less QE" factor, is the reason why we see limited room for retracements towards the 1.3650/1.37 zone. In fact, it has already returned to 1.39. In any case, this latent risk in the periphery may restrict the euro's room for reversal once QE2 is announced in the US (in principle no higher than 1.40).

Chart 3

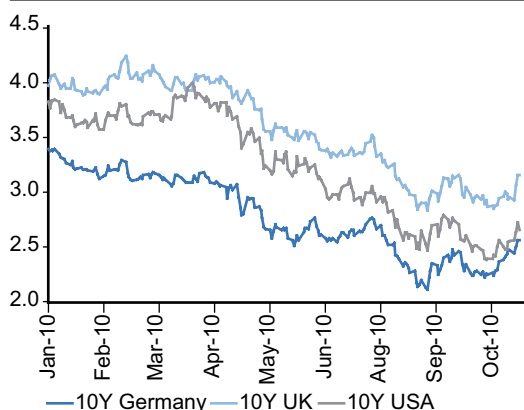
Sovereign risk 5-yr CDS (bps)



Source: Bloomberg

Chart 4

10Y Govt Rates: Germany, US and UK



Source: Bloomberg

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Strong growth in the German economy

Following the unexpected strong growth in the German economy in Q2 (3.7%y/y), recent both hard and soft indicators suggest that the recovery is ongoing in the second half of the year, albeit clearly at a more moderate pace. On the one hand, retail sales and consumers' confidence along with the good news coming from the performance of the labour market point to a stronger role of the domestic economy, making the export-led recovery more sustainable in H2 2010. In addition, industrial orders rebounded again in August, suggesting that further industrial investment should be needed in coming months. On the other hand, export growth in July-August remained resilient after reaching pre-crisis levels. Still limited data showed further evidence that the economic outlook remains positive at the beginning of Q4. Overall, German GDP growth is projected to increase by 3.2% in 2010, with some upside risks in Q3 and Q4 figures. But domestic demand must continue to improve in order to sustain current growth. There are some positive factors that will push domestic demand higher like: a resilient labour market, improved public finance performances, which will require less fiscal adjustment, and a possible increase in wages, after IG Metall asked for a pay increase. On top of that we expect the German GDP growth to moderate to around 2% in 2011, mainly due to a worse global economic momentum and a strong euro.

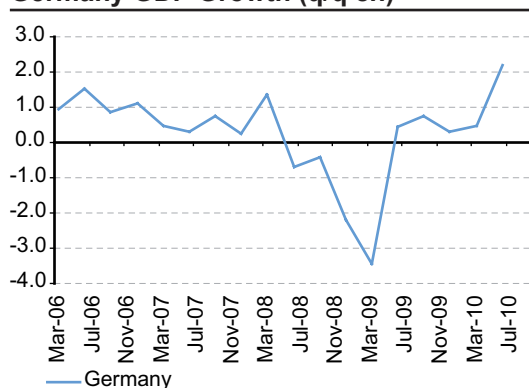
Today's high US unemployment rates as a result of the business cycle

We consider today's high US unemployment rates are mostly the result of the business cycle rather than mismatch. However, high unemployment rates lead to long-term unemployment if not corrected quickly. This supports the efforts of the Federal Reserve to correct the cycle. Even if unemployment today is corrected by measures combating the cycle, in the end we face job creation demands that remain unresolved within the current US institutional framework for innovation and industrial growth. Next week the October unemployment rate is expected to remain at around 9.6%. This level is far from our current NAIRU forecast (6.5%). For further information see: [Economic Watch: High unemployment duration can lead to structural problems](#).

Fiscal consolidation in European Peripherals still a point of concern

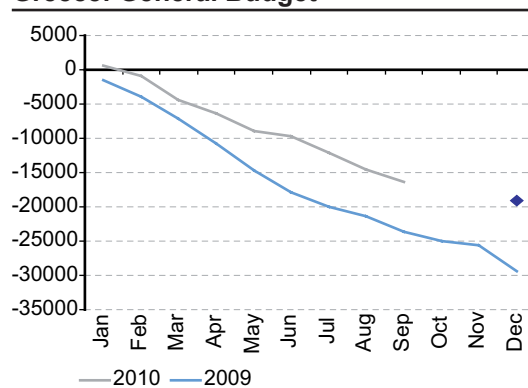
Recently doubt has increased on Greece fiscal execution because fiscal revenues are coming in lower than expected, but slightly above last year's trend. However, lower military expenditures and higher nominal GDP growth, due to higher than expected inflation, leads us to think that the Greek government will meet the 2010 deficit target (7.8%). Regarding Ireland, the Irish government will unveil by mid-November the details of fresh austerity measures (up to €15 bn) with the aim to achieve the 3% deficit target in 2014 as cyclical and bank-related effects are swallowing up previous tightening measures. Additionally the Irish government's offer to bondholders of the Anglo Irish Bank could reduce some pressure on public finance (the Government could recover 1.6 bn) by shifting part of the cost of the bail-out to bondholders; nevertheless, actions that could be undertaken and uncertainty that can be generated in the market on bank debt holders will generate short-term stress. In Portugal, budget execution is behind the target, which has forced the government to announce additional measures. Some of them are included in the State Budget for 2011 and they are enough (amount to 3% of GDP) to meet the deficit target of 4.6% in 2011. In this context we understand that lack of support for the 2011 Portuguese budget has caused financial strains. In our opinion, factors such as the European pressure, the huge financial strain that will take place if the bill is not approved, and that the PSD is not against a deficit cut leads us to think that the opposition party will abstain in the vote on the 3rd of November, allowing the budget to be approved. Finally, the Spanish fiscal execution has been in line with the 2010 government's target, up to now, and the government found support to approve the Budget for 2011. Our view is that fiscal consolidation in some Peripherals is a reason for concern, but the strong government commitment to the deficit target and the good fiscal performance in Spain may deter an increase in systemic risk premium.

Chart 5

Germany GDP Growth (q/q ch)

Source: BBVA Research

Chart 6

Greece: General Budget

Source: Hellenic Ministry of Finance, Datastream

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Calendar: Indicators

Eurozone: Retail sales (September, November 5th)

Forecast: 0.3% m/m	Consensus: 0.1% m/m	Previous: -0.4% m/m
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Comment: We expect retail sales to increase timidly in September, after falling in the previous month. Overall, these figures should mean that retail sales in Q3 would grow around 0.5% over Q2, suggesting that private consumption should increase further in Q3, after growing by 0.2% q/q in the previous quarter. Nevertheless, we continue to see subdued households' spending in coming months as a high unemployment rate persists.

Market Impact: A negative surprise could be seen as a sign of weakness in households' spending, although a positive surprise is not ruled out and thus, despite the weakness of domestic demand, its support to economic recovery could be larger than previously expected.

Germany: Industrial new orders (September, November 5th)

Forecast: 0.4% m/m	Consensus: 0.0% m/m	Previous: 3.4 m/m%
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Comment: Following the robust increase observed in August, industrial new orders are likely to slow again in September. Looking forward, orders are expected to moderate substantially in coming months in line with managers' perception as reported in PMI's surveys, although they could remain relatively resistant supported by export orders. These data, coupled with industrial production figures, are showing further evidence of the slowdown in the industrial sector. **Market Impact:** In part due to the volatility of orders and partly because a significant moderation in orders growth is expected, a negative surprise should not affect the markets greatly, but it could raise concerns about a more severe slowdown by the end of the year.

US: FOMC Statement (November, November 3 rd)

Forecast: 0.25%	Consensus: 0.25%	Previous: 0.25%
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Comment: The Fed is expected to announce a second round of quantitative easing (QE2) during the next FOMC meeting on Nov 2-3rd. In addition, the discussion on economic and financial conditions is likely to result in a downward revision to the macroeconomic forecasts. Market expectations currently point to the purchase of \$1trillion of additional long-term treasury securities; however, a more gradual approach is also feasible. **Market impact:** Markets have been waiting for this meeting since the Fed first signaled the possibility of a policy change. However, if Fed announces QE2 with a smaller-than-expected amount or explicitly rejects the idea, markets could react negatively.

US: Nonfarm Payroll & Unemployment Rate (October, November 5th)

Forecast: 68K, 9.6%	Consensus: 45K, 9.6%	Previous: -95K, 9.6%
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Comment: October's nonfarm payroll is expected to increase for the first time in fourth months. Job creation has been driven by sustained growth in private services employment. Meanwhile, government layoffs will continue at the federal and local level, though at a slower pace. Although private employment has increased steadily since the beginning of the year, the expansion has not been enough to reduce the unemployment rate. In fact, the u-rate is expected to remain flat at 9.6% for the third consecutive month. **Market impact:** Positive employment figures will be well received; however, some cautiousness is likely to prevail as figures will continue to portray a slow recovery.

Brazil: Trade Balance (October, November 1st)

Forecast: USD 1.800 millions	Consensus: n.a.	Previous: USD 1.093 millions
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Comment: October's trade balance is expected to be around 65% higher than in September and 27% higher than the monthly average in the year. Year to date, the Brazilian trade balance, is expected then to accumulate USD 14.566 millions, which will be 35% less than in the same period last year. This deterioration is due to both the dynamism of domestic demand and the appreciation of the exchange rate. **Market Impact:** Impacts will be limited.

China: PMI (October, November 1st)

Forecast: 52.3	Consensus: 53.8	Previous: 53.8
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Comment: data on retail sales and fixed asset investment have showed considerable growth momentum in recent months, as have indicators on railway freight shipments and other manufacturing indices. In line with these developments, we expect manufacturing activity to continue expanding in November. However, due to seasonality, the purchasing managers' index will likely fall below the previous monthly reading. **Market impact:** Following the recent surprise interest rate hike, a stronger-than-expected reading may heighten expectations of another imminent round of tightening measures, including another interest rate hike.

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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	1
		2-yr yield	0.36	1	-6	-53
		10-yr yield	2.64	9	13	-74
	EMU	3-month Euribor rate	1.05	2	15	33
		2-yr yield	1.00	0	17	-29
		10-yr yield	2.54	7	27	-69
Exchange Rates (changes in %)	Europe	Dollar-Euro	1.384	-0.6	1.6	-6.1
		Pound-Euro	0.87	-2.0	0.4	-3.0
		Swiss Franc-Euro	1.37	0.4	2.4	-9.4
	America	Argentina (peso-dollar)	3.96	0.0	-0.1	3.6
		Brazil (real-dollar)	1.70	0.0	0.6	-3.0
		Colombia (peso-dollar)	1836	0.6	1.9	-8.0
		Chile (peso-dollar)	489	0.4	1.1	-8.1
		Mexico (peso-dollar)	12.40	0.1	-1.6	-6.2
		Peru (Nuevo sol-dollar)	2.80	0.1	0.3	-3.9
	Asia	Japan (Yen-Dollar)	80.75	-0.9	-3.2	-10.3
		Korea (KRW-Dollar)	1124.70	-0.2	-1.2	-5.4
		Australia (AUD-Dollar)	0.973	-0.8	0.7	8.2
Comm. (chg %)		Brent oil (\$/b)	83.1	0.1	0.9	10.5
		Gold (\$/ounce)	1339.1	0.8	2.3	28.1
		Base metals	546.6	0.1	3.5	24.2
Stock Markets (changes in %)	Euro	Ibex 35	10697	-2.1	1.7	-6.3
		EuroStoxx 50	2828	-1.6	2.9	3.1
	America	USA (S&P 500)	1184	0.1	3.7	14.2
		Argentina (Merval)	2955	3.6	11.8	39.7
		Brazil (Bovespa)	70320	1.1	1.3	14.3
		Colombia (IGBC)	15662	-1.6	6.5	46.6
		Chile (IGPA)	22761	1.6	1.8	45.4
		Mexico (CPI)	35377	0.7	6.1	23.5
		Peru (General Lima)	18991	1.2	6.3	33.6
		Venezuela (IBC)	67342	0.5	3.2	32.6
	Asia	Nikkei225	9202	-2.4	-1.8	-8.3
		HSI	23096	-1.8	3.3	6.2
Credit (changes in bps)	Ind.	Itraxx Main	98	-1	-13	10
		Itraxx Xover	458	0	-51	-64
	Sovereign risk	CDS Germany	34	1	-5	14
		CDS Portugal	360	14	-49	304
		CDS Spain	210	6	-19	140
		CDS USA	38	0	-9	---
		CDS Emerging	203	-7	-24	-76
		CDS Argentina	618	-122	-133	-398
		CDS Brazil	99	0	-17	-38
		CDS Colombia	101	-1	-17	-67
		CDS Chile	77	2	-6	1
		CDS Mexico	105	-2	-17	-65
		CDS Peru	104	1	-17	-40

Source: Bloomberg and Datastream

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