

# Weekly Watch

Madrid, 12 November 2010

## Economic Analysis

### Financial Scenarios

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## European Governance in the Spotlight

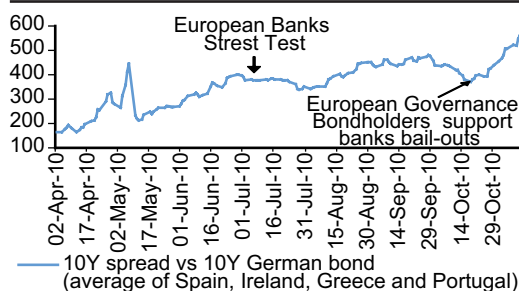
After the G-20 summit failed to agree over trade imbalances, exchange rates and financial regulations, investors will likely turn their attention on domestic issues. Meanwhile, in the US, in a relatively less busy week, economic releases were better-than-expected. In Europe 3Q GDP grew 0.4% q/q slowing from the 1% q/q pace in 2Q. This preliminary data suggests a better performance of domestic demand, pointing to a more sustainable recovery. Nonetheless, earlier this week, mainly two events in European peripheral countries contributed to a sharp increase in risk premiums: 1) differing points of view concerning the permanent crisis resolution mechanism –albeit all are considering bail-ins, to some extent–, and 2) worse than expected performance of public finances in peripheral countries –news that Greece won't achieve its 2010 public deficit target; and a lack of market confidence on Portugal's budget target. Sovereign risk spreads in European peripheral countries returned this week to alarming levels i.e., above May's maximum levels. Moreover, measures of default risk (5-year CDS spread) have risen dramatically in these countries during the last month.

### What can we expect?

Our view is that the market has already priced in a very negative scenario for European peripheral countries. The joint statement made by the finance ministers of the main European countries pointing out that the debate regarding SDRM does not apply to any outstanding debt or to the EFSF mechanism, along with our view that ECOFIN ministers, ECB members, and a European Commission official (Van Rompuy) will express in the same direction, should prevent any further increase in the risk premium. That being said, two events next week might maintain uncertainty at high levels. First, the EU, ECB and IMF officials' visit to Greece to supervise progress ahead of the third disbursement due in November. Second, the uncertainty surrounding peripherals' debt issuance next week. In following weeks, other events could impact on sovereign risk: the European Commission growth and deficit forecast, at the end of November, and the Irish Budget that will be presented on December 7th.

Chart 1

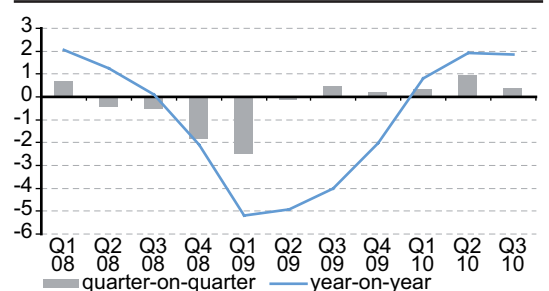
### Sovereign risk has accelerated in Europe



Source: BBVA Research

Chart 2

### Eurozone: GDP growth



Source: Eurostat

Markets



## Highlights

Highlights



### The current reform of economic governance in the EU

There are two broad approaches to reform fiscal discipline: reinforcing the Stability and Growth Pact (SGP), and or imposing market discipline through a sovereign-debt restructuring mechanism.

Calendar



### G20 meeting: the shadow of QE2 prevents advances in policy coordination

The G20 summit ended today without surprises. Among the issues on the agenda were the regulatory reform, and the rebalancing of both currencies and global demand.

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### Inflows to EM markets investment fund

Since the beginning of September 2010 net inflows to EM fixed income and Equity funds have grown 38% and 63%, respectively.

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**Global factors' should give way to local risk-return issues**

The most noteworthy feature of currency crosses has been the sharp correction in the EURUSD, 5 figures in just four days, even dropping below 1.37 EURUSD. This movement was not primarily a reflection of a strengthening USD, but rather a weakening EUR. Behind this movement appears to be a new resurgence of periphery risk, driven on this occasion by noise surrounding future financial aid for countries in difficulties, which is currently being debated and which Germany wishes to make stricter. This situation allows us to anticipate a scenario in the short term for the forex market of a waning impact from global factors. Therefore, although the underlying scenario points to global depreciation of the dollar on the back of QE2, favouring a return in the EURUSD to around 1.40, short-term risk factors may delay his trend, above all in the near term.

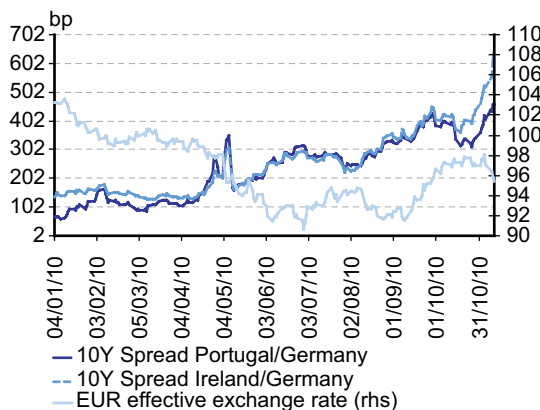
**The rise in sovereign risk is causing decoupling across equity markets and sectors**

Sovereign risk is starting to cause some decoupling across equity markets and sectors, something which has not been seen to date. At the country level, emerging equity markets (economic cycle) and US equity (QE2 measures) have continued to outperform Europe, with the periphery lagging behind in the latter. Cyclical and debt-laden sectors are performing worst than defensives. This is mainly a result of the increase in cyclical risk generated by the scenario. However, on a positive front, this new environment does not seem, at least for the time being, to be leading to a systemic risk premium. Equity volatility remains contained, with the VIX at 19% and the V2X at 23.5%.

**Peripheral concerns continue to weigh on European credit**

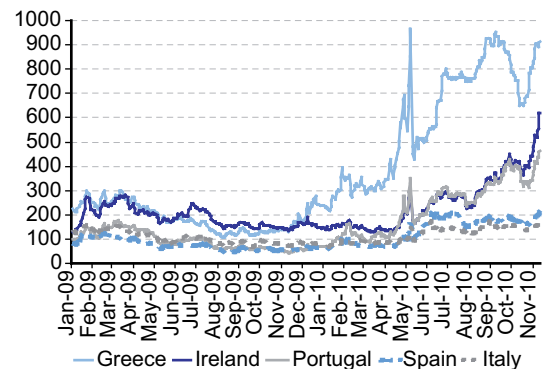
The Quantitative Easing 2 (QE2) announcement initially had a soothing effect on Credit Markets and triggered significant tightening on the day of the announcement. However, since last Thursday 4 November all iTraxx Indices have widened: iTraxx Main +10bps, HiVol +10bps and XO is 30bps wider. In Financials, we would highlight Sub-Financials which peaked at +41bps w/w to 236. Much of this weakness is explained by sovereign contagion which is clearly punishing the broader corporate and financial credit markets. Summing up, peripheral concerns continue to weigh on European credit which has pushed the SovX-Main spread to a record wide of 71bps.

Chart 3  
**Spreads vs Euro Real Effective Exchange Rate**



Source: BBVA Research

Chart 4  
**Sovereign spreads (spread on 10-y bonds against Germany, pbs)**



Source: Bloomberg

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**The current reform on economic governance in the EU**

There are two broad approaches to reform fiscal discipline: reinforcing the Stability and Growth Pact (SGP) through early automatic sanctions (defended by the EC and ECB), and or imposing market discipline through a sovereign-debt restructuring mechanism (SDRM) that makes bondholders pay. There is a broad consensus on a reinforced SPG, but not on the possibility of overruling sanctions by the EU council through qualified majority vote, as currently proposed by the Council. These decisions have been surrounded by political debate, due to differing positions between northern countries (mostly Germany) and others on the nature of such a mechanism and its relative importance vis-à-vis a simple reform of the stability and growth pact. Financial markets have shown renewed nervousness in the past few weeks as the establishment of the EFSF ensuring help for three years (until mid-2013) did not dispel fears because of doubts on the effective implementation of the aid and the lack of backing for debt after those three years, and because of the possibility that a new debt restructuring mechanism implies a loss for bond holders. A complete agreement will likely not be decided by December by the EU Council, so market stress is likely to continue, unless the accord includes the most important and fundamental aspects of the SDRM.

**G20 meeting: the shadow of QE2 prevents advances in policy coordination**

The G20 summit ended today without surprises. There were some advances on the regulatory front, but no big surprises: the September Basel III agreement was endorsed and greater focus was put on emerging countries and broad guidelines to address the “too-big-to-fail” problem. The definition and treatment for systemic institutions will be postponed until mid 2011. Interestingly, the backlash from the announcement of QE2 severely hampered the ability of the US to steer the G20 agenda. Incidentally it also helped take China and the exchange rate of the renminbi out of the spotlight. In the end, there were only soft mentions to ensuring exchange rate flexibility and reducing volatility, in such a way that most countries could feel they are already satisfying those pledges. Instead, the communiqué announced future work towards guidelines to identify large external imbalances. This way, the focus has shifted from misaligned exchange rates to misaligned external positions, which is a welcome development. Nevertheless, at the end of the day, the summit came out with nothing but good intentions and soft declarations on the big issues of balancing of demands and currency realignment, postponing once again dealing effectively with both issues. As this was expected, financial markets were more affected by other news from China and Ireland. We expect continued exchange rate volatility as the opportunity for policy coordination was missed.

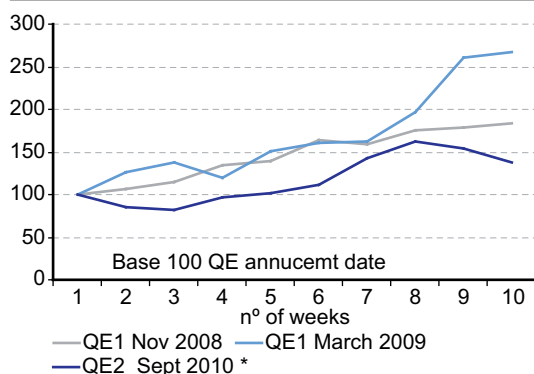
**Inflows to EM markets investment fund**

Year to date inflows to Emerging markets’ funds have been quite large. Fixed income and Equity Emerging market funds along with the fixed income international fund (that includes some emerging market funds) are experiencing the highest growth rates. The expectation of QE2 in the US accelerated inflows since September: from Bernake’s signal of the likelihood of QE2 (August 27th) to the first week of November, net inflows to EM fixed income and Equity funds have risen 38% and 63%, respectively. In our view, the search for yield in a context of stronger fundamentals in emerging economies, low global risk-aversion, and the expectation of very low yields in developed economies in the foreseeable future will continue supporting capital flows to emerging markets. These hot money flows will keep appreciation pressures on their currencies and thus, authorities are thus likely to attempt to postpone monetary policy tightening even in a context of strong growth momentum. Yet, despite concerns about capital inflows and currency appreciation, rising inflation is still foremost in the minds of policy makers. For instance, in response to a faster-than-expected pace of inflation in October, the People’s bank of China (PBoC) implemented further tightening measures i.e., another 50bp hike in the required reserve ratio.

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Chart 5

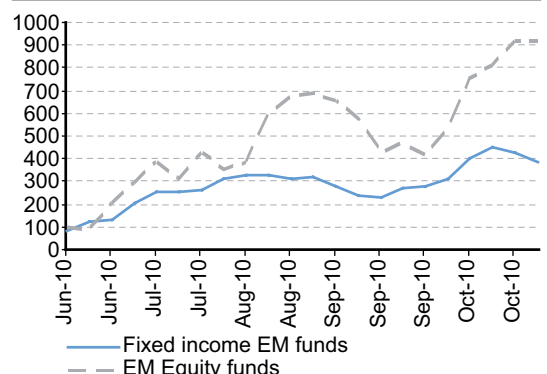
**Inflows to fixed income EM dedicated funds**



\* Bernanke’s declarations in Jackson Hole  
Source: BBVA Research

Chart 6

**Recent trend in inflows to investment funds**



Source: BBVA Research

## Economic Analysis

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## Calendar: Indicators

## Eurozone: Trade balance (September, November 15th)

<b>Forecast:</b> €-0.3bn	<b>Consensus:</b> n.d.	<b>Previous:</b> €-1.4bn
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**Comment:** The trade deficit is likely to narrow in September, as exports are expected to grow similarly to last month, while imports are expected to grow at a lower rate. These figures should imply a clear deceleration in growth of both exports and imports in Q3 over Q2, especially the latter. Overall, trade balance data for Q3 as a whole suggest that net exports could have contributed positively to quarterly GDP growth in Q3, after the 0.2pp printed in the previous quarter. **Market Impact:** A negative surprise could have a relevant market impact by raising concerns about the main driver of the recovery, i.e. the external sector.

## Germany: ZEW Economic Sentiment (November, November 16th)

<b>Forecast:</b> -7.0 points	<b>Consensus:</b> -4.0 points	<b>Previous:</b> -7.2 points
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**Comment:** We expect ZEW economic sentiment to have remained broadly stable or even to improve slightly in November. Since this indicator reflects economic agents' expectations over the next six months, compared with the economic situation a year earlier, we see this indicator getting close to a cyclical minimum. This is to the extent that economic agents are beginning to price some stabilization in the pace of the recovery, but at rates clearly below those observed in H1 2010. In contrast, the current situation subcomponent is likely to increase slightly again, boosted by positive news from the labor market, but it should be also close to a cyclical maximum. **Market Impact:** A large negative surprise could have a relevant market impact as it would signal the lack of faith of analysts in the strength of the recovery in the main pillar of the Eurozone right now –the German economy.

## US: Industrial Production (October, November 16th)

<b>Forecast:</b> 0.4% m/m	<b>Consensus:</b> 0.3% m/m	<b>Previous:</b> -0.2% m/m
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**Comment:** In September, industrial production declined 0.2% after increasing 13 out of the last 14 months. The index had risen 9.2% during the same period. Although total industrial production jumped 4.8% at an annual rate in 3Q10 it is still only 0.2% higher than its level in September 2008. Regional Fed and ISM manufacturing surveys indicate that the U.S. economy is growing at a moderate pace. Therefore, we expect industrial production to increase moderately in October. **Market impact:** Strong growth in industrial production would imply stronger-than-expected economic growth in 4Q10 and be welcome by the markets.

## US: Consumer Price Index, core (October, November 17th)

<b>Forecast:</b> 0.3% m/m, 0.1% m/m	<b>Consensus:</b> 0.3% m/m, 0.1% m/m	<b>Previous:</b> 0.1% m/m, 0.0% m/m
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**Comment:** Core consumer prices, measured by excluding energy and food prices, were flat in September and it was the lowest level since March 1961 on a YoY basis. On the other hand, headline consumer prices increased by 0.1%, equivalent to 1.1% over the last 12 months. We expect disinflationary pressures continue to limit price increases in the short term. However, in the long run, further monetary easing announced by the Fed on November 3rd will eliminate some of these pressures. **Market impact:** Market is expecting 0.3% increase in headline inflation mainly due to increase in energy prices. A negative surprise such as a decline in core or headline prices would increase deflationary worries even further.

## Japan: Q3 GDP growth (Q3, November 15th)

<b>Forecast:</b> 2.6% q/q ann	<b>Consensus:</b> 2.5% q/q ann	<b>Previous:</b> 1.5% q/q ann
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**Comment:** Exports, the main driver of Japan's economic recovery, are weakening, and business investment and private consumption are expected to sustain growth instead. Business investment is expected to grow steadily, thanks to a recovery of corporate profits. Japan's recovery has slowed since the second quarter (1.5% q/q, annualized) as exports are losing momentum and domestic demand remains weak. We forecast GDP growth of 3.0% and 1.6% respectively in 2010 and 2011. Meanwhile, the economy also continues to struggle with deflation. **Market impact:** Weaker-than-expected growth will further dampen expectations for the outlook, already dragged down by the strong Yen.

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## Markets Data

			Close	Weekly change	Monthly change	Annual change
<b>Interest Rates</b> (changes in bps)	<b>US</b>	3-month Libor rate	0.29	0	0	1
		2-yr yield	0.45	8	7	-36
		10-yr yield	2.65	12	14	-77
	<b>EMU</b>	3-month Euribor rate	1.05	0	6	34
		2-yr yield	0.95	3	15	-25
		10-yr yield	2.45	3	15	-94
<b>Exchange Rates</b> (changes in %)	<b>Europe</b>	Dollar-Euro	1.365	-3.0	-2.9	-8.6
		Pound-Euro	0.85	-1.8	-3.0	-4.6
		Swiss Franc-Euro	1.33	-1.4	-0.6	-11.9
	<b>America</b>	Argentina (peso-dollar)	3.96	0.3	0.2	3.8
		Brazil (real-dollar)	1.72	2.3	3.3	-0.3
		Colombia (peso-dollar)	1858	2.0	3.0	-5.6
		Chile (peso-dollar)	480	0.6	0.4	-4.2
		Mexico (peso-dollar)	12.29	0.7	-1.1	-5.8
		Peru (Nuevo sol-dollar)	2.80	0.3	0.4	-2.6
		Japan (Yen-Dollar)	82.11	0.9	0.8	-8.3
	<b>Asia</b>	Korea (KRW-Dollar)	1127.72	1.9	1.4	-2.5
		Australia (AUD-Dollar)	0.988	-2.7	-0.5	5.9
	<b>Comm.</b> (chg %)		Brent oil (\$/b)	87.0	-1.3	2.9
		Gold (\$/ounce)	1382.2	-0.8	0.1	23.6
		Base metals	568.4	1.8	4.6	25.7
<b>Stock Markets</b> (changes in %)	<b>Euro</b>	Ibex 35	10063	-3.5	-7.2	-15.2
		EuroStoxx 50	2794	-2.9	-1.5	-3.1
		USA (S&P 500)	1214	-1.0	3.4	11.0
	<b>America</b>	Argentina (Merval)	3341	-0.3	22.3	49.6
		Brazil (Bovespa)	71195	-1.9	-0.7	9.0
		Colombia (IGBC)	15460	-5.0	0.0	37.8
		Chile (IGPA)	23192	0.9	4.2	47.7
		Mexico (CPI)	36305	0.0	4.2	17.1
		Peru (General Lima)	20595	0.9	5.6	41.5
		Venezuela (IBC)	67665	0.1	2.2	29.5
	<b>Asia</b>	Nikkei225	9725	1.0	1.5	-0.5
HSI		24223	-2.6	1.6	7.4	
<b>Credit</b> (changes in bps)	<b>Ind.</b>	Itraxx Main	106	9	5	21
		Itraxx Xover	462	32	0	-56
	<b>Sovereign risk</b>	CDS Germany	38	2	6	17
		CDS Portugal	479	36	106	416
		CDS Spain	277	29	77	201
		CDS USA	41	0	0	---
		CDS Emerging	204	14	10	-59
		CDS Argentina	634	33	-60	-356
		CDS Brazil	101	8	9	-22
		CDS Colombia	102	7	8	-47
		CDS Chile	77	2	-6	1
		CDS Mexico	109	10	9	-39
		CDS Peru	116	13	19	-12

Source: Bloomberg and Datastream



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