BBVA Research

Global

Weekly Watch

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Economic Analysis

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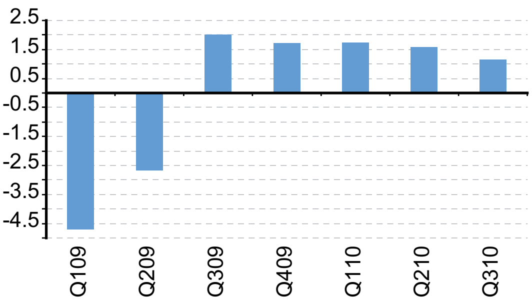
All focus on the FOMC …

The absence of relevant macro data surprises has shifted all market interest towards the FOMC meeting next week. Although there are increasing speculations about a second round of quantitative easing, we do not expect any major changes at this venue, primarily due to the absence of large negative surprises since the last gathering. In this context, the Fed might wait until the next two-day monetary meeting to be held in November, when projections for GDP growth, unemployment and inflation are released. The US data flow continued to point to a steady moderation through Q3, with unemployment figures edging somewhat down but still high and manufacturing numbers slowing markedly against Q2. In Europe, this week's data revealed that the export recovery might dampen in the months to come, although it remains resilient due to the support of Asian economies.

… while European bond markets start to show some signs of market differentiation

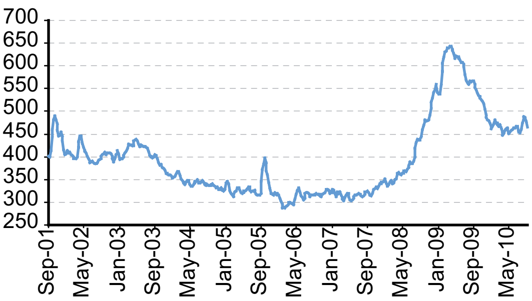
Contrary to many expectations, although the current situation remain a cause for concern, European bond markets start to show signs of market differentiation, with Spain and Italy performing somewhat better than many of their peers, particularly after last sovereign bond and bill auctions showed relatively positive outturns vis-à-vis their 'neighbours'. Whether this trend is sustainable or not will depend on market perceptions rather than in real facts, thus new episodes of financial stress should not be ruled out at all.

Chart 1
USA: Industrial production index (manufacturing; 3M moving average %; sa)



Source: Datastream and BBVA Research

Chart 2
USA: Initial jobless claims (4 week moving average; thousands)



Source: BLS and BBVA Research

Highlights

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Greece on the road

Greece has been on the news in recent weeks. Although the state of things in the banking sector is far from normalized, the support shown by IMF, EC and ECB officials during the road-show started in London this week looks impressive, suggesting that that everything will be done to avoid a default as things are progressively getting on track.

The FOMC at centre stage

The FOMC members will meet again next week. Although there are speculations about whether the Fed will announce a second round of quantitative easing (QE2) or change its policy on interest paid on excess reserves, we expect no change in the Fed's monetary policy stance at least until the next two-day venue to be held in November when projections for GDP growth, unemployment and inflation are released.

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Markets

All eyes on central banks

Over the last few weeks, the market has placed increasing importance on information published by central banks, turning them into veritable market drivers. On one hand, the BoJ and Japanese MoF acted to put a brake on the appreciation of the yen and on the other the market is anticipating potential extension of unconventional measures by the Fed.

Will the yen remain strong, and the dollar weak?

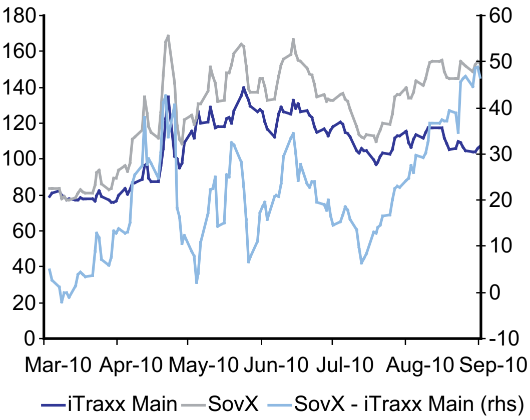
In terms of the yen, while risk premiums remain high, with limited gains for equity and OECD rates heading towards the bottom of their ranges the appreciation of the Japanese currency may continue to fail to reflect its fundamentals.

Also, if the FED limits itself to maintaining a proactive rhetoric with regards to medium-term laxity, but without this resulting in a need to strengthen stimuli, this would reinforce our idea that a return to the lows in rates seen in August is less likely (2.40% 10Y Treasury). In all, rises in rates may well be slower and limited. In this context, the dollar would find more convincing reasons to limit falls.

Increased differentiation between corporate and sovereign debt

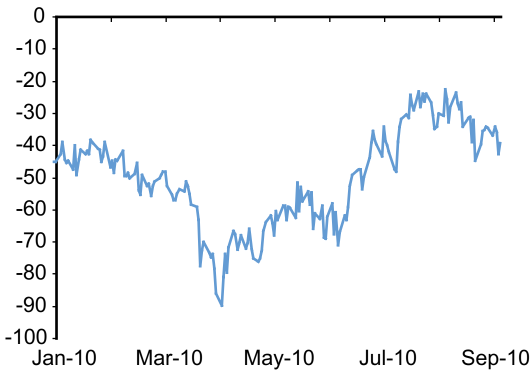
Following the recent rally witnessed in credit at the start of September, this week there has been something of a slowdown, caused by investors taking profits and resetting short positions. In this context, we would highlight the increasing underperformance of the SovX (152bps) versus the iTraxx Main (106bps). The spread differential reached a new record high this week (50bps) after the lukewarm reception of Portugal's 12-month bills auction (Wednesday) and negative momentum for Ireland (Anglo Irish Bank was downgraded by S&P to BBB+). In this unfavourable context for peripheral credit, we note the differentiation that investors now seem to be making between Portugal and Ireland versus Spain and Italy (the SovX weakening this week being driven by the former). In fact, we have seen evidence of this in the different success that Portugal's and Spain's bond auctions have had this week. For Portugal, the average rate paid by the government was substantially higher than in its previous auction (3.369% vs. 2.756%) while its bid-to-cover ratio only reached 1.6x versus 2.1x at the start of the month. In contrast, yesterday's 10 and 30 year bond auctions from Spain were a clear success. The Spanish Treasury allotted EUR2.7bn in 10-yr bonds at an average yield of 4.144% (versus 4.864% in June) and a 2.32x bid-to-cover ratio (versus 1.89x in June). In 30-yr bonds, the Treasury auctioned EUR1.28bn at an average rate of 5.077% and 2.1x bid-to-cover ratio, (compared to the previous 5.908%).

Chart 3
Credit spreads (bps)



Source: Markit and Bloomberg

Chart 4
Spread 10Y Govt Germany-US (bps)



Source: Bloomberg

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Highlights

Greece on the road

Greece has been on the news in recent weeks as the Ecofin approved in early September the second tranche of help to the country for 9 bn euro (out of the total 110 bn available), while the Greek finance minister started a road-show in London on Wednesday to convince investors that the country is on track. Spreads continue to be very high, and this has been compounded by liquidity problems in Greek banks, which are losing deposits and maintain the highest dependency on ECB financing in the eurozone, with no signs of improvement as recently observed in other countries. Comments on the chances of Greek to avoid a debt restructuring abound in the press, and while many see it inevitable, the support shown by IMF, EC and ECB officials during the road-show looks impressive, suggesting that everything will be done to avoid a default. The good news is that the fiscal plan remains on track, even surpassing the goal of sharp consolidation for this year. Although revenues lag behind what was projected and have grown below projections, spending cuts have been deeper than projected and the deficit target of -8.1% in 2010 will probably be surpassed. The IMF-EC summer review previous to the second tranche warns however that there is uncertainty on the finances of hospitals, local authorities and some public enterprises, and the lack of revenue creates some uncertainties. The other good news comes from structural reforms, which are in some cases ahead of schedule (notably the pensions reform, which is very ambitious and sets stricter pensions parameters than those of many EU countries), but the ones remaining or in drafting stage are precisely those which are more linked to potential growth: the labour reform and liberalization of many professions. Greece has a problem of competitiveness that has to be addressed through price moderation, and although wage growth is now almost flat, inflation runs high as VAT hikes have been fully passed through to prices. Supply-side reforms are therefore key for the recovery. On activity, GDP growth continues to be negative, and current indicators suggest that stabilization has been reached, but still at negative rates –the IMF-EC maintain their projection of GDP fall of -4% this year and -2.5% in 2011. The uncertainty surrounding the recovery and the achievement of sustainable growth, and the fact that debt will be close to 150% of GDP even if the programme succeeds, are the main issues of concern.

The FOMC at centre stage

The FOMC members will meet again next week. Although there are speculations about whether the Fed will announce a second round of quantitative easing (QE2) or change its policy on interest paid on excess reserves, we expect no change in the Fed's monetary policy stance at least until the next two-day venue to be held in November when projections for GDP growth, unemployment and inflation are released. As it was stressed a couple of times by Mr. Bernanke, the Fed's main concerns are the financial stability, inflation and economic recovery. The Fed will make cost and benefit analysis before taking new actions and recent statements of FOMC members indicate that there is no need for a policy change at this moment. Although the economic recovery is slower than the Fed's expectation, financial stability seems prudent and inflation is under control. We expect that unless there is significant threat to financial stability which might negatively affect economic recovery and unless there are significant and clear signs of deflation, the Fed will continue to implement its current monetary policies.

The previous minutes and Bernanke's speech at Jackson Hole last month reflect the Fed's desire to accurately communicate the purpose of the Treasury purchase plan. The Fed wants to ensure that the market interprets a constant balance sheet as a way for the Fed to remain neutral rather than signaling a QE2. In addition, we expect the Fed will not reduce the interest on excess reserves in line with Mr. Bernanke's recent statements. Since his speech at Jackson Hole, the economic data have come somewhat better than expected but economic slack continues to be a drag on prices. Therefore, there is no reason to believe the Fed would announce a policy change next week.

Although recent inflation indicators point to a slowdown trend, given the fact that inflation expectations are reasonably well-anchored, and both inflation expectations and actual inflation remain within a range consistent with price stability, changing monetary policy with current information might entail much greater costs than benefits. Core consumer prices, which exclude volatile energy and food prices remained unchanged in August, with 12-month core inflation at 0.9% since April. Although there is a probability of a deflation scenario in the short term, the odds are still low. The Fed is closely watching inflation dynamics and we believe the FOMC members still do not expect this scenario. However, if inflation surprises starts coming negative for the next few months then we might expect some change in Fed's policies but it is still too early to speculate. Therefore we believe that inflation is likely to remain low but positive in 2010. We also believe the Fed will continue to be cautious and will delay interest rate hikes at least until 3Q11, which would ensure low interest rates for an extended period of time.

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Calendar: Indicators

USA: FOMC Meeting (September 21st)

Forecast: 0.25%	**Consensus:** 0.25%	**Previous:** 0.25%

Comment: We are expecting that the Fed will continue its low interest rate policy in the medium term. The federal funds rate is expected to remain at 0.25% and we continue to anticipate that the Fed would start increasing interest rates no sooner than 3Q11. As it was made clear by the current Fed's chairman Bernanke in his speech in Jackson Hole last month, the Fed is ready to do whatever it takes to support the economy if economic outlook worsens significantly. However, he also noted that there is no significant risk worth acting on, at this moment. Since his speech, the economic indicators have come out stronger than expected and therefore, although there are some discussions in the market on the possibility and need of a second round quantitative easing (QE2), we expect no change in the Fed's current monetary policy at this week's FOMC meeting. **Market impact:** If the Fed announces a QE2, the market would be caught unguarded and it would decrease long term rates further if, for example, the Fed decides to increase its large-scale purchases of treasury securities significantly.

USA: Durable Goods Orders (August, September 24th)

Forecast: -1.5% m/m	**Consensus:** -0.9% m/m	**Previous:** 0.4% m/m

Comment: Durable goods orders are expected to decline in August following a 0.4% increase in July, which was due to increase in nondefense aircrafts and parts component which is basically demand for commercial aircrafts. Market will be closely watching the release since it could give insights for the pace of the recovery. Durable goods orders increased 9.3% in the last 12 months although the pace of its growth seems to be fading away. **Market impact:** A positive surprise in new durable goods orders would imply a stronger than expected economic activity and could point to a stronger industrial production in the coming months.

Eurozone: Industrial new orders (July, September 22nd)

Forecast: -0.3% m/m	**Consensus:** -1.4% m/m	**Previous:** 2.5% m/m

Comment: Industrial new orders are expected to decline slightly in July, following the sharp growth observed in May and June, which meant that orders accumulated a strong quarterly increase of around 8% q/q in Q2. Nevertheless, a stronger decline in new orders is not ruled out due to the high volatility of this series. Soft data from managers' surveys also reveal a slowdown in new orders, especially from abroad. Overall, these figures continue to suggest that industrial recovery is moderating, after having reached a cyclical peak in Q2. **Market Impact:** A large negative surprise would rise concerns about the path of expansion in the industrial sector, although given the volatility of the series small devations are not likely to have a large impact on markets.

Eurozone: Flash PMI Composite (September, September 23rd)

Forecast: 55.5	**Consensus:** 55.7	**Previous:** 56.2

Comment: We expect the composite PMI indicator to fall again in September, after having been hovering around 56.5 points in the previous months, slightly below the cyclical peak reached in April. Overall, the average of the indicator in Q3 should be slightly below than that recorded in Q2, suggesting that the eurozone economy is slowing in the current quarter, but not very fast. The fall of the composite index should reflect a further deterioration of confidence in manufacturing, while services sentiment will remain more resilient. **Market Impact:** A larger fall in one month than the one we project is unlikely, but would be undoubtedly received as a sign of a rapid deterioration in the outlook for the second half of the year.

Taiwan: Export Orders (August, September 20th)

Forecast: 19.5% y/y	**Consensus:** 21.3% y/y	**Previous:** 18.2% y/y

Comment: Export orders in August, a leading indicator of exports in the coming three months, are likely to ease further, due to the expected softening of external demand in the second half of the year. However, due to base effects, the year-on-year growth rate may be slightly higher than the previous month. **Market impact:** a reading significantly below expectations could renew concerns about the health of the global economy as well as the outlook for the region's export-dependent economies.

Markets Data

				Close	Weekly change	Monthly change	Annual change
Interest Rates	(changes in bps)	US	3-month Libor rate	0,29	0	-5	0
			2-yr yield	0,46	-10	-2	-53
			10-yr yield	2,74	-5	17	-72
		EMU	3-month Euribor rate	0,88	0	-1	12
			2-yr yield	0,78	4	12	-51
			10-yr yield	2,44	4	12	-94
Exchange Rates	(changes in %)	Europe	Dollar-Euro	1,306	2,7	1,8	-11,3
			Pound-Euro	0,83	0,8	1,6	-7,8
			Swiss Franc-Euro	1,32	1,7	-0,5	-13,0
		America	Argentina (peso-dollar)	3,95	0,0	0,3	2,9
			Brazil (real-dollar)	1,72	-0,1	-2,6	-5,1
			Colombia (peso-dollar)	1809	0,5	-0,5	-7,2
			Chile (peso-dollar)	499	0,4	-1,9	-8,6
			Mexico (peso-dollar)	12,81	-1,1	0,6	-3,4
			Peru (Nuevo sol-dollar)	2,79	-0,1	-0,4	-3,6
		Asia	Japan (Yen-Dollar)	85,78	1,9	0,5	-6,0
			Korea (KRW-Dollar)	1158,50	-0,4	-1,7	-4,0
			Australia (AUD-Dollar)	0,939	1,4	5,1	8,0
Comm.	(chg %)		Brent oil ($/b)	77,9	-0,3	3,4	9,2
			Gold ($/ounce)	1276,6	2,4	3,6	26,7
			Base metals	517,3	1,2	3,0	17,6
Stock Markets	(changes in %)	Euro	Ibex 35	10645	-0,4	4,0	-9,6
			EuroStoxx 50	2768	-0,4	3,5	-4,1
		America	USA (S&P 500)	1127	1,6	4,8	5,5
			Argentina (Merval)	2456	0,8	1,1	22,3
			Brazil (Bovespa)	67235	0,6	0,5	10,8
			Colombia (IGBC)	14014	-0,9	4,3	28,4
			Chile (IGPA)	22500	1,8	6,4	44,9
			Mexico (CPI)	33047	1,3	2,8	10,4
			Peru (General Lima)	16687	3,3	12,2	10,2
			Venezuela (IBC)	66794	2,3	2,8	24,7
		Asia	Nikkei225	9626	4,2	2,8	-7,2
			HSI	21971	3,4	4,3	1,6
Credit	(changes in bps)	Ind.	Itraxx Main	107	2	-4	20
			Itraxx Xover	472	-3	-26	-59
		Sovereign risk	CDS Germany	40	0	-2	20
			CDS Portugal	340	9	68	290
			CDS Spain	230	3	14	165
			CDS USA	47	0	0	---
			CDS Emerging	235	-15	3	-32
			CDS Argentina	767	-113	-54	-443
			CDS Brazil	114	-11	-6	-2
			CDS Colombia	120	-10	0	-24
			CDS Chile	77	2	-6	1
			CDS Mexico	125	-11	7	-22
			CDS Peru	117	-8	15	-6

Source: Bloomberg, Datastream and JP Morgan

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