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Economic Analysis
March 23, 2012

Global Weekly Flash

Gloomy mood in financial markets this week

Persisting doubts about fiscal consolidation progress in peripheral Europe and, more recently, the increasing uncertainties of lower-than expected outlook for Chinese growth, together with the persistence of high oil prices are the main worries affecting the global outlook. Meanwhile, Fed officials are trying to adjust expectations.

- **Some stabilization in long-term rates following last week's sell-off**
  - The recent sell-off in long-term bonds was driven by a reduced probability of further QE and with tail risks fading. Following a somewhat upbeat FOMC statement, the market priced out QE3 and also pull forward hike expectations (we thought the latter was too aggressive). Fed hike expectations (began to?) recede this week after US existing home sales negatively surprised and following Bernanke's comments ("Higher energy prices would probably slow growth, at least in the short run") which confirmed that QE3 is still not off the table ie, while it is true that its likelihood has decreased, it remains possible and data dependent. Dec13 fed fund futures declined 5bp but are still pricing in that the Fed will raise rates as early as Dec13 (trading at 47bp). As a result, long-term yields partially reversed the recent increase, with 10y yields declining 12bp from its recent high (reached on Monday).
  - As regards to German Bund yields, an increase in risk aversion, due to continued concerns which are now gradually focusing in Spain (Spanish bond yields are well above those of Italy again, a sign that Spain is a bigger worry), is behind this week's decline. 10y German Bund yields declined 18bps from its recent high (also reached on Monday) and are now slightly below 1.9%, that is, at the (relatively stable) average of the past few months.
  - This week's stabilization was expected; a sustained sell-off in bond markets (ie, a resumption of the rate increases seen recently) is unlikely in the near-term. Provided that the Fed maintains its guidance about zero short rates, Fed hike expectations still have room to be downwardly revised, and thus, there is a limit to the feasible sell-off of Treasuries. Meanwhile, concerns as regards peripheral Europe are likely to continue and thus, a sustained sell-off in German bonds is quite unlikely.

- **European Peripheral old worries on fiscal side**
  - In spite of the CDS liquidation was uneventful, the European debt crisis is far from over and uncertainty persists in some specific areas. In particular, risks on peripheral countries still remain. For countries under programme, i.e., Greece, Portugal and Ireland, but also for Spain and Italy, the challenge is to continue with the implementation of fiscal consolidation in the middle of a recessionary environment. In the case of Spain an additional uncertainty comes from next week's presentation to Congress of a new budget proposal for 2012, where additional measures aimed at guaranteeing the achievement of this year's fiscal targets are expected to be announced.
  - However not all are bad news, Greece said the budget gap dropped in first two months of 2012 to EUR495mi from EUR1.05bn in the he same period last year. The deficit was below the government's EUR879mi target. In Portugal, the general government deficit was broadly on track in the first two months of this year but Social Security showing sign of deterioration.
  - Activity data in the eurozone surprised on the downside. The EZ March flash PMIs were released, suggesting that the private sector fell deeper into contraction, with all indices showing below 50 readings. Composite index stood at 48.7, reflecting deterioration in the manufacturing sector. In Germany only manufacturing fell into contraction territory, while services and composite maintained growth, while in France services remained flat, at 50.0p, and the industry declined. Construction output in the Eurozone fell slightly in January, while current account showed a surplus on the month and a narrowed deficit in the last 12 months accumulated (-EUR 21.2bn versus –EUR 50.6bn the previous year). Industrial new orders improved in France (+0.7% m/m), while fell in Italy and Greece (-7.4% m/m and 15.7% y/y in January).

- In this context, it is crucial to strengthen the European firewall. The current EFSF lending capacity committed to Irish, Portuguese and the new Greek programs amounts to EUR188.2bn. To this, other payments are expected. There are EUR 35bn of additional resources to buy back the Greek bonds held by the Eurosystem, as agreed in the second Greek bailout. Furthermore resources to recapitalize banks also need to be charged against the stability mechanism. To these, it should be added the funds needed to recapitalize banks in the EU periphery. Lastly it is very probable that Portugal will need a second aid package. The revision of the joint EFSF/ESM lending capacity, currently capped at EUR500bn, is expected to take place next Friday, at the EU Council meeting.
- Regarding this revision, the European Commission has presented three possible options for strengthening the sovereign firewall, which will be considered in next week's summit meeting. The first option would increase the EFSF/ESM's total lending capacity from EUR500 to EUR700bn, by combining the full ESM capacity with the already used EFSF capacity (200 bn). Hence, the additional firepower of this option would be limited to EUR 500bn. The second option combines the full ESM and EFSF capacity temporarily. Therefore the ESFS/ESM ceiling would be EUR940bn until 30 June 2013, when the EFSF expires. The new lending capacity under option two would be temporarily increased to EUR 740bn until 30 June 2013 (500bn from ESM plus 240bn of unused EFSF funds). In our opinion, although the firepower of this option is enough to prevent contagion among peripheral countries if complemented with further IMF funds, , the increase in lending capacity would be reduced to 500bn when the EFSF expires (30 June 2013), probably before many peripherals can access financial markets. Finally, the third option would transform the unused EFSF guarantees (EUR 240bn) into additional subscribed capital of the ESM, which would be permanently increased to EUR 740bn (while temporarily would be combined with the already compromised 200bn from the EFSF). This is the boldest option, which would fulfil the IMF requirement of strengthening the eurozone firewall (allowing them to provide new funds), helping to convince markets. However, this option will likely be opposed by Germany. In our view, the option with more chances to be approved would be option 2, possibly with an extension of the temporary combination of ESM and EFSF funds.

- **Recent economic data have intensified fears of a hard-landing in China, while other Asian countries are showing signs of bottoming-out**
  - The Chinese flash estimate came out at 48.1%, down from 49.5% in February, the lowest reading since November. New orders were down to 46.1 from 48.5 in February, while the export orders index rose to 48.7 from 47.5 in February. The official Manufacturing PMI index will be release next week. Additionally, China's official 70-city housing price index for the month of February showed a seventh consecutive m/m decline. We estimate that nationwide housing prices had shown a cumulative decline of a modest 1.2% since last July. This outturn is in line with our expectations of modest price declines this year, although price declines have been somewhat larger in individual markets where overvaluation has been most significant, including Beijing, Shenzhen and Shanghai. However, we continue to expect overall domestic demand to be robust during the remainder of 2012, facilitated by growth-supportive policy stance. In this regard, this week, the authorities have announced a cut in the required reserve ratio for the Agricultural Bank of China to boost credit growth.
  - Meanwhile Taiwan's export orders turn up in February increasing 17.6% y/y from -8.6% y/y in January. After combining January and February figures together, signs of improvement are evident.

Calendar: Indicators

Eurozone: M3 (February, March 28th)

Forecast: 2.4% y/y	Consensus: 2,5% y/y	Previous: 2.5% y/y

We expect M3 to have slowed down slightly in February, after the sharp increase observed in the previous month. Nonetheless, recent non-standard measures implemented by the ECB make the forecast of this series more uncertain. Across its counterparts, our estimate is that loans to private sector should have remained flat in February, though with significant differences across sectors, with loans to households increasing timidly up to February over Q4 (around 0.1%), while those to firms declining by around -0.6% and deepening the downward trend observed by end-2011. Overall, these figures raise doubts about the pace of the recovery in coming quarters.

Eurozone: Flash HICP inflation (March, March 30th)

Forecast: 2.6% y/y	Consensus: 2.5% y/y	Previous: 2.7% y/y

Headline inflation is expected to ease in March from 2.7% to 2.6% y/y. Despite higher oil prices, we continue to expect a favorable base effect in March after the strong energy inflation observed a year ago (around 13% y/y). Regarding inflation of other components, our forecast suggests that it should have remained broadly unchanged, resulting in the stabilization of core inflation at 1.9% y/y. Looking forward, we now only expect a slower moderation in inflation in coming months as a result of recent increases in oil prices along with a milder than expected slowdown of activity, which has been apparent over Q1. As a result, HICP inflation should remain slightly above the ECB target all through 2012.

US: GDP, Final Estimate (4Q11, March 29th)

Forecast: 3.0% q/q a	Consensus: 3.0% q/q a	Previous: 3.0% q/q a

The final estimate for 4Q11 GDP growth should remain near 3.0% given that most of the relevant data has already been accounted for. The second estimate was revised up due to increased nonresidential fixed investment and personal consumption expenditures as well as a downward revision to imports. Inventory growth has been the main driver of 4Q11 GDP growth, with business inventories revised up slightly for December. Productivity growth was also revised up for the fourth quarter, reflecting a higher estimate for total output. However, the trade deficit for December was larger than previously thought and will likely offset any upward revisions to other GDP components. Personal spending data was unrevised for December, so we do not expect any changes to the PCE estimate.

US: Personal Income and Outlays (February, March 30th)

Forecast: 0.3%, 0.6% m/m a	Consensus: 0.4%, 0.6% m/m a	Previous: 0.3%, 0.2% m/m a

Personal income and outlays are expected to increase in February as consumer activity regains some momentum. Average earnings increased again in February and should lift personal income for the month, with increasing income expectations indicating continued growth. On the spending side, a jump in retail sales suggests that nominal outlays will likely increase at a faster pace than in January, though mostly due to higher gas prices. In real terms, we expect that personal consumption expenditures will remain relatively flat as they have been for the past three months.

China: PMI for March (March, April 1st)

Forecast: 51.0	Consensus: n/a	Previous: 51.0

The official PMI outturn will be closely watched following recent indications of a further slowing in growth momentum. The private sector flash PMI estimate came in weaker than expected on March 22, raising expectations of a decline in the forthcoming PMI outturn after 3 consecutive months of a pick-up. Although underlying growth momentum is weakening, we expect the official PMI to remain unchanged from the previous month due to a seasonal rebound from the Chinese New Year in January. A more significant set of indicators will be released in mid-April, including Q1 GDP, industrial production, retail sales, and investment.

Markets Data

				Close	Weekly change	Monthly change	Annual change
Interest rates	(changes in bps)	US	3-month Libor rate	0.47	0	-2	17
			2-yr yield	0.35	-1	5	-38
			10-yr yield	2.23	-7	22	-121
		EMU	3-month Euribor rate	0.81	-4	-21	-40
			2-yr yield	0.23	-10	-3	-150
			10-yr yield	1.87	-18	-2	-141
Exchange rates	(changes in %)	Europe	Dollar-Euro	1.327	0.7	0.2	-5.8
			Pound-Euro	0.84	0.4	-1.2	-4.9
			Swiss Franc-Euro	1.21	-0.1	-0.1	-6.9
		America	Argentina (peso-dollar)	4.37	0.2	0.3	8.0
			Brazil (real-dollar)	1.82	0.9	6.6	9.7
			Colombia (peso-dollar)	1760	0.0	-1.2	-5.9
			Chile (peso-dollar)	489	1.4	1.1	2.2
			Mexico (peso-dollar)	12.83	1.4	0.0	7.0
			Peru (Nuevo sol-dollar)	2.67	-0.1	-0.4	-4.4
		Asia	Japan (Yen-Dollar)	82.14	-1.4	2.2	0.9
			Korea (KRW-Dollar)	1135.81	0.9	0.7	2.3
			Australia (AUD-Dollar)	1.043	-1.5	-1.8	1.8
Comm.	(chg %)		Brent oil ($/b)	125.2	-0.5	1.9	8.3
			Gold ($/ounce)	1665.0	0.3	-6.3	16.5
			Base metals	542.0	-1.1	-0.4	-13.5
Stock markets	(changes in %)	Euro	Ibex 35	8259	-2.7	-4.6	-22.9
			EuroStoxx 50	2512	-3.7	-0.3	-13.7
		America	USA (S&P 500)	1392	-0.8	2.6	6.0
			Argentina (Merval)	2690	-2.7	-5.2	-19.7
			Brazil (Bovespa)	65968	-2.5	-0.2	-2.7
			Colombia (IGBC)	14666	-1.5	0.7	0.7
			Chile (IGPA)	21840	0.3	1.9	0.5
			Mexico (CPI)	38406	0.4	1.3	4.4
			Peru (General Lima)	22813	-0.7	-0.3	2.6
			Venezuela (IBC)	186328	9.1	36.9	160.3
		Asia	Nikkei225	10011	-1.2	4.8	5.0
			HSI	20669	-3.0	-4.1	-10.8
Credit	(changes in bps)	Ind.	Itraxx Main	118	-1	-16	15
			Itraxx Xover	600	71	14	214
		Sovereign risk	CDS Germany	74	5	-8	27
			CDS Portugal	1223	-57	93	676
			CDS Spain	433	34	58	206
			CDS USA	31	-2	-6	---
			CDS Emerging	239	18	-13	31
			CDS Argentina	734	-3	-32	133
			CDS Brazil	122	2	-16	8
			CDS Colombia	109	1	-19	-5
			CDS Chile	90	4	-6	25
			CDS Mexico	116	4	-18	8
			CDS Peru	121	0	-26	-5

Source: Bloomberg and Datastream

Weekly Publications

Country	Date	Description
US	03/21/2012	**Economic Watch: Uncertainty: Models and Impacts** Efficiency enhancers allow for near-real time uncertainty modeling
	03/20/2012	**Banking Watch: When Credit Breaks** Dating Structural Breaks in Credit Data
	03/19/2012	**Flash U.S: Weekly Flash. Retail Sales Give Boost to Economic News, Energy Prices Drive Headline CPI** Retail sales jumped 1.1% in February following a revised 0.6% increase in January, mostly due to a 1.6% rebound in auto sales *(Chinese version)* *(Spanish version)*
EMU	03/19/2012	**Event: What impact is regulation having on the European financial services sector?** Regulation and the European Financial Sector. Rapporteur: Rafael Doménech and Santiago Fernández de Lis Event: Wilton Park Conference "Financial Regulation in the European Union: The Impact on The Economy and The Financial Services Sector". Frankfurt, March 19-21, 2012
	03/18/2012	**Articulos de Prensa: Reestructurando los sistemas de pensiones** La combinación de las tendencias demográficas y la crisis actual, subraya la necesidad de ir avanzando hacia reformas profundas en las pensiones. **Autor:** David Tuesta **Fuente:** El País
Spain	03/20/2012	**Flash España: "Balanza comercial de enero 2012"** El déficit de la balanza comercial en el acumulado a 12 meses de enero disminuye sustancialmente y se sitúa en -45,1 mil millones de
Latin America		
Brasil	03/22/2012	**Brazil Flash: "Unemployment and inflation surprise to the downside"** The unemployment rate reached 5.7% in February, the lowest rate for the period and slightly below marketexpectations (5.9%).
Colombia	03/22/2012	**Flash Colombia: Muy buen 2011: economía creció 5,9% anual impulsada por demanda privada (9,6% anual)** En 2011 la economía se expandió 5,9% anual, con un fuerte repunte de la actividad en el segundo semestre del año. La demanda privada se expandió por encima del nivel del PIB
Mexico	03/22/2012	**Inflation during March's first fortnight: downwards surprise caused by agricultural and processed food prices and cancellation of the car owners tax** General: Actual: 0.05% f/f vs. BBVA: 0.33% f/f Consensus:0.19% f/f. Core: Actual: 0.43% f/f vs. BBVA:0.29% f/f Consensus:0.22% f/f *(Spanish version)*
	03/21/2012	**Mexico Flash: US Baby boomers in Mexico: a growing group of immigrants** Mexico Census indicates that 961,121 people born abroad live in Mexico, 76.4% of them from the U.S. *(Spanish version)*
Asia	03/22/2012	**Daily Flash | Asia | 22 March 2012: weak flash PMI estimate in China; Japan posts first trade surplus in five months and the yen strengthens** Sentiment was down following the release of the HSBC flash estimate of March PMI in China which suggests a further slowdown while markets in India closed sharply lower on weak European PMI data.
	03/21/2012	**Daily Flash | Asia | 21 March 2012: Thailand holds rates; Guandong province pension fund may diversify into equities** A number of media outlets have been citing China's slowing growth outlook as a factor for weakening market sentiment. In our view, China's slowing growth and economic rebalancing are not new.
	03/20/2012	**Daily Flash | Asia | 20 March 2012: Taiwan's export orders turn up in February; China increases fuel prices; China hints at interest rate liberalization** Despite weakness in Asian markets today, we see signs of an emerging rebound in Asian exports. Recent PMI outturns in China and better-than-expected export orders in Taiwan point to rising exports.
	03/19/2012	**Daily Flash | Asia | 19 March 2012: Decline in China's housing prices; India's budget receives mixed reviews** Chinese government released its monthly survey on home prices which showed a further cooling in the property sector, in line with Premier Wen's comments on housing prices being above reasonable levels

Publications on March 23, 2012 to 10:30, Madrid time

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