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Economic Watch

Europe

Madrid, July 17, 2012
Economic Analysis

Europe

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Eurozone: Growth prospects worsen in Q2

Bottom line: Incoming data for the Eurozone in Q2 suggests negative growth at -0.2% q/q, with downside risks, after a stagnated economy in Q1. Confidence started the Q2-2012 with strong falls, but was less negative at the end of the quarter, while industrial production recovered somewhat in May after bad figures in April. Across countries, Germany seems to have also entered negative figures in Q2. The ECB lowered further its base rate to 0.75%, while financial conditions remain tense, as the market rallies associated to the election results in Greece and to the agreement of the EZ summit at end June were short-lived.

The improvement in confidence during Q1 was followed by a sharp and broad-based deterioration in Q2, somewhat mitigated in June

After the rebound in confidence observed during Q1 (+1.7p), more pessimism returned to Eurozone throughout Q2 (-4.6p), as evidenced by the Economic Sentiment Indicator (ESI) from the European Commission. There is a significant deterioration in all sub-indices, with consumer sentiment the sector less hit by the downturn. In May alone, the index fell by 2.4p to 90.5, while in June the drop was milder (-0.6p), with services suffering the most, followed by industry. By country, France (-1.5) and Germany (-1.4) reported the strongest drops in June, while UK (+1.9), Spain (+1.0) and Italy (+0.9) saw a rebound. At the same time, the business climate, as tracked by the BCI index, was also down in June, for a fourth month in a row, losing 0.15 points to -0.94, driven by increased pessimism in all components.

The PMI surveys in Q2 contributed further to the negative atmosphere, with the Eurozone Composite index remaining in contractionary territory for the fifth month in a row in June, though improving from 46.0p in May to 46.4p. By country, the composite index in Germany fell deeper below the no-change level of 50 (down by 1.2p), while in France it gained 2.7p, though remaining in contraction territory. In Italy it registered a slight drop (-0.2p).

The industrial sector entered Q2 on a bad footing, but a positive reversion followed in May

The industrial sector made a bad start in Q2 taking the slump for a third month in 2012, with production falling by a revised -1.1% m/m in April and the only upward pressures coming from increased energy production, which however was not enough to offset the fall of the rest components, especially capital goods. Nevertheless, in May industrial production reversed its negative trend, with an increase of 0.6% m/m coming from all sub-indices but energy. The latest trend observed in moving averages till May in Germany showed meagre but positive growth in production (+0.2%), less resilience in France (-0.6%) and a flat rate in Italy. Some positive news are coming from new orders, which increased for two months in a row in March-April (+2% and +0.4% m/m respectively). Looking further ahead, the prospects for the remaining of Q2 do not look very encouraging, as both PMI and ESI surveys posted a pessimistic result for manufacturing. The ESI index for industry flinched by -3.7p in May-June, reflecting a strong deterioration in the assessment of order books and production (past and future), while the PMI manufacturing index fell to 45.1p, nearly a three-year low, with a deepened downturn during May, as evidenced in steep drops in both output and new orders. Ireland was the only country still in expansionary territory and Germany, Italy and Spain fell, narrowing the divergence between core and non-core countries.

Neither the services sector managed to show resilience, with both ESI and PMI surveys pointing to a sharp deterioration. In particular, ESI services confidence decreased by 5.0p during the last two months (May and June), stemming from a marked deterioration in the assessment of past business, demand and expectations, though the services PMI improved slightly to 47.1 in June, nevertheless signalling a downturn of similar size with May (at 46.7). On a country level, German PMI services stagnated, while in the rest of the countries the indices improved.

Consumer confidence has stabilized in negative numbers, while unemployment reached record high

Sentiment among consumers deteriorated at the beginning of Q2, and then remained stable in negative territory in May and June (+0.6p in May, -0.5p in June), driven by increased unemployment fears and less optimism about the future economic situation. On average, in Q2 confidence was somewhat lower compared to the end of Q1 (by 0.6p). The confidence index for retail trade partly recovered in June (+3.2p) from the sharp drop in May (- 7.0p) on a more positive assessment of current and future business situation, but it was still by 2.7p lower on average in Q2 than at end-Q1. In the real economy, retail sales started Q2 in red, after rebounding during end-Q1, with activity in the sector falling by 1.0% in April and recovering 0.6% in May.

The labour market stagnation continues. The unemployment rate reached a record high of 11.1% in May, after the unchanged 11.0% in April. While in most of the countries the rate remained broadly stable (with France up by 0.1pp and Italy down by 0.1pp), Greece and Spain saw for yet another month their rates increasing, by 0.3pp and 0.5pp respectively. In addition, employment plans were revised downwards in all business sectors, with the largest drops in services and manufacturing.

Eurozone continues posting trade surpluses

Latest data indicates that external trade activity has been improving, with consecutive surpluses registered. According to data for May, exports were stronger and imports were weaker (+0.3% and -0.9% m/m respectively). What is more, the recent trend of trade surpluses continues, with trade balance reaching €6.9bn in May, after €3.7bn the previous month. In Germany, latest data for May shows that both exports and imports increased strongly, in Italy the rise in exports was more pronounced that for imports in May, while France saw its deficit slightly narrowing. Furthermore, on a three-month moving average basis, France exports and imports are trending upwards, with imports following closely the performance of exports and in Germany exports are moving slightly up and imports slightly down.

Out MICA model predicts a GDP fall of -0.2% in Q2, slightly below our mid-May projection

Eurostat confirmed that the Eurozone economy stagnated in Q1, on the back of further external support. The strong growth in Germany (+0.5% q/q) and the milder contraction in several periphery countries were accountable for this better than expected result. By component, private consumption remained stable, after experiencing a drop of -0.5% q/q in Q4, while investment fell more than in Q4 (-1.4% vs -0.4% respectively). On the external front, exports were by 1% stronger (after -0.7%), while imports only registered a 0.1% growth (after -1.7%), with a positive net external contribution of 0.4%.

Our short-term GDP forecast model (MICA-BBVA) suggests that Eurozone economy will contract by -0.2% q/q, but with risks being titled to the downside (-0.3% q/q). This implies a slight downward revision compared to our latest Outlook in May (-0.1% q/q). For the whole year we expect a contraction in Eurozone GDP of -0.2%.

Inflation decelerates, after being stable during Q1

Inflation remained unchanged in June, for the second month in a row at 2.4% y/y, after remaining broadly stable at 2.7% y/y during each month of the first quarter. Our expectation was for a slowdown driven by both energy and core inflation. The lowest rate for June was observed in Greece (1.0%).

Energy inflation slowed further, even somewhat more than anticipated, but this was completely offset by the acceleration observed in fresh food inflation, which surprised on the upside. We continue to expect a slower moderation of prices in coming months, with inflation remaining above the ECB target over the next quarter and reverting to around 2% by the end of the year. Core inflation is likely to ease slightly to remain hovering around 1.7% y/y during the second half of the year. Risks to this scenario remain balanced.

ECB sets record-low rate of 0.75%, as recession spreads to the core of Europe

Eased monetary policy by the ECB, as downside risks materialize...

As expected, the ECB cut the key policy rate by 0.25%, bringing it to a record low of 0.75%, while leaving unrevised the interest rate corridor (at +/-75bp), therefore leaving the deposit rate at 0%. The decision was unanimous and a result of the materialization of downside risks to the outlook. With respect to non-standard measures, the ECB did not announce any extra measures, although Mr Draghi said that the collateral framework will have to be revised. In this context, he wanted to emphasize that the ECB will keep all liquidity lines open to solvent banks.

...but we do not expect more rate cuts in the near future

In the Q&A session, Draghi added that the ECB sees growth weakening in the whole euro area. However, he emphasized that its "baseline scenario has not changed" and they still see a gradual and slow recovery near the year-end". In this context, Mr Draghi did not hint any additional cut in the short-term. We do not see further immediate actions in both standard and non-standard measures, beyond some fine tuning in collateral rules. However, new actions cannot be discarded if the financial crisis escalates again in coming months.

Developments in the periphery

Greece: Towards renegotiation of the adjustment program

The Greek economy contracted for yet another quarter in Q1-2012 and scenarios about a Greek euro exit after the inconclusive results of May 6 elections increased. However, the formation of the three-party coalition government (consisting of New Democracy, PASOK and DEMAR), following June 17 elections, paved the way for the continuation of the program with the troika.

The new government obtained a confidence vote at the beginning of July for its policy program. Its nine points plan focuses on privatizations and attraction of investments, although the fiscal measures to be implemented in 2013 have still to be determined. In the short-term, the government will attempt to re-negotiate some of the terms of the bailout, starting with an extension of the program by two years, which would require further funds from the troika.

On fiscal developments, budget execution for H1 can be assessed positively, with a deficit of €2.3bn, undershooting the target by €2.6bn. This improvement reflects a larger than expected decrease of expenditures (at €35.7bn almost 4bn below the target), while revenue targets were once again missed (€21.8bn against target of €22.8bn), mainly due to the extension for tax declarations and to lower transaction tax collection.

Italy: fiscal targets revisited, followed by new austerity measures

Amid stronger contraction of economic activity, as reflected in the negative growth rate of GDP in Q1-2012 (-0.8% q/q), Italy postponed its deficit targets by one year due to lower than expected growth projections, although the target for 2013 is still very low (-0.3% of GDP against 0% under previous projections). After the latest EU Summit, the government moved on with new spending cuts of €26bn until end 2014, with €4.5bn for 2012, €10.5bn in 2013 and €11bn in 2014. This year's spending measures aim at avoiding the increase of VAT by 2%, which has been postponed until mid-2013. Among other measures, public sector staff and managers will be reduced by 10% and 20% respectively, provincial governments by half, soldiers by 10% and spending on healthcare will be further slashed.

On budget execution, data up to June showed that state government's deficit improved significantly by attaining only 29.1bn, compared to 43.9bn in the same period of 2011. However, general government deficit in Q1-2012, widened to 8% of GDP (7% in 2011), reflecting a fall of 1% y/y in revenues and a 1.3% y/y rise in expenditures, with debt service rising to 16% y/y, due to rising yields on public debt. These contradictory pieces of information make any prediction difficult, but together with the new measures they suggest that the deficit target for this year of 1.7% of GDP should not be missed by a large amount.

Ireland: The troika completes its seventh visit, giving a positive evaluation

During the first half of July troika visited Ireland to complete its 7th review on the adjustment program, finding its implementation to be on track, while some macroeconomic challenges remain present. The disbursement of €2.6bn will be followed by the next review in October.

According to the assessment, growth prospects for 2012-2013 are subdued, as export demand is weakening. Unemployment remains high and the troika is considering plans to use resources of the European Investment Bank for several sectors, including education, healthcare and transport.

Markets' reaction has turned positive recently, especially after the EU summit that open the possibility of direct recapitalization of Irish banks by the ESM. Indeed, the Irish treasury issued bills this month for the first time since the intervention of the Irish economy.

On the fiscal front, deficit targets have been met during the first half of 2012, with revenues rising faster than expected. In particular, according to budget execution data, overall revenues up to June beat the target by 3.1%, while the slippages in expenditure amounted to €0.2bn and could be adjusted by the end of the year.

Portugal: Fourth review of troika once again applauds Portugal's efforts

The mission of the troika completed its fourth review at the beginning of June, giving a positive assessment, and highlighting their continued confidence on the feasibility of fiscal targets. Unemployment, which international creditors see peaking at 16% in 2013, is considered a major challenge, but is seen as a by-product of the transition to a more export-oriented economy (and as a result of rigidities in the labour market). The next review is scheduled for September.

The deficit at the central government including Social Security from January to May is estimated at €1.2mn, compared to a figure of about €300mn in the same period last year. Although it is still premature to draw conclusions, budget execution so far shows that the budget is falling behind targets, especially on indirect taxes, which fell by 5.7% compared to 2011. On the spending side, the good performance in current spending (i.e. reduction in public consumption, purchase of goods and services) is overshadowed by the increase in the interest rates bill and capital expenditure.

In the meantime, the government now estimates the GDP growth at 0.2% in 2013, well below the 0.6% it estimated in April, while it revised upwards its forecast on unemployment, now foreseeing a peak at 16% in 2013 (peak at 14.5% in 2012 previously).

Spain: The EFSF will release 30bn for the banking system by the end of July, while new fiscal measures have been announced

Following last EU Summit, the Eurogroup agreed on the draft of the MoU underlying the financial assistance for the recapitalization of the Spanish financial institutions, which is expected to be signed on July 20. The financial aid will be provided via the EFSF until the ESM becomes available without seniority status. A first tranche amounting to €30bn will be available by the end of July to have it ready in case of emergency. The conditionality would be very strict for those banks receiving public capital, particularly regarding holders of non-senior debt and segregation of impaired assets. Meanwhile horizontal conditionality would be mainly concerned with solvency and the supervisory and provisioning system, and a closely monitoring of liquidity conditions of the system.

Additionally, the Eurogroup gave an extra-year to Spain to bringing its deficit below the 3% of GDP level, with headline deficit targets of 6.3% of GDP for 2012, 4.5% of GDP for 2013 and 2.8% of GDP for 2014. On July 17, the Spanish government announced measures amounting to €65bn through 2014, that significantly increase the likelihood of meeting the new public deficit target at the end of 2012 (6.3% of GDP). Measures include a hike in the top VAT rate from 18% to 21% (and the medium rate from 8% to 10%, while moving some products from lower rates to higher ones); suppressing the Christmas payment for civil servants in 2012, and reorganizing and reducing local administration to save costs.

EU summit 28/29 June: Positive surprises, but no game changer

The EU summit provided some positive surprises in measures to reduce stress in financial markets in the short term. EU leaders decided to allow the ESM to directly recapitalize banks once common supervision is implemented (in about six months), while the ESM senior status is dropped for banking aid to Spain. The EFSF/ESM will be available for intervention in bond markets with no additional macro conditionality to the one already defined under normal EU recommendations, although countries requesting for this aid will have to sign a MoU. Still, the available funds by the EFSF or ESM may be short for large and decisive interventions. In addition, a growth package of €120bn was approved, as expected, and although not insignificant (1% of GDP), this aid is not completely new and will not be enough to support growth in the eurozone periphery.

There was not much on the fiscal and banking union, apart from rapid moves to common supervision under ECB, which are positive. President Van Rompuy will present a further report in October. In a sense, it was positive that the summit focused mostly on short-term measures rather than only on the long-term institutional framework, as had been widely expected before the summer.

Overall, despite significant positive news, the new measures do not constitute a game changer, as witnessed by market reaction, which also reacted to implementation risks to the various measures proposed. Nonetheless, the summit was an important step in the right direction larger than expected.

Tables and graphs: Economic indicators

Table 1
Main indicators for Eurozone countries

		Euro Area	Germany	France	Italy	Spain	UK	Portugal	Greece	Ireland
					National Accounts					
Mar-12										
GDP	q/q	0.00	0.51	0.03	-0.82	-0.32	-0.32	-0.07	-7.62	-1.10
	y/y	0.00	1.18	0.29	-1.42	-0.41	-0.18	-2.24	-6.53	1.20
	2011 y	1.61	3.00	1.70	0.43	0.71	0.65	-1.65	-6.91	0.70
Mar-12										
Industrial Production	m/m	0.55	1.55	-2.06	0.84	0.93	1.01	4.08	0.29	1.37
	q/q	-0.89	-1.17	1.16	-1.77	-2.18	-0.03	-2.48	-0.64	2.55
Apr-12	**(*)**									
Industrial new orders	m/m	-1.17	0.60	2.99	-3.54	-3.92	-0.50	1.14	-2.60	-4.03
	q/q	0.00	0.68	1.98	-1.14	-3.46	-1.51	0.42	-2.80	-3.74
Jun-12										
ESI	Level	89.90	100.50	91.80	79.70	89.10	92.90	77.90	74.10	n.a.
	Change	-0.60	-1.40	-1.50	0.90	1.00	1.90	0.90	-1.90	n.a.
Jun-12										
PMI Manufacturing	Level	45.07	45.04	45.20	44.61	45.10	48.58	n.a.	40.97	48.26
	Change	0.00	-0.15	0.53	-0.21	1.41	2.70	n.a.	-1.06	-0.34
Jun-12										
PMI Services	Level	47.13	49.91	47.93	43.15	46.10	51.30	n.a.	n.a.	48.25
	Change	0.46	-1.85	2.84	0.37	4.03	-2.01	n.a.	n.a.	-0.18
					Consumption					
Jun-12										
EC Consumer Confidence	Level	-19.80	0.40	-16.00	-38.60	-33.20	-21.80	-52.10	-75.80	n.a.
	Change	-0.50	2.70	4.20	-2.30	-4.60	2.60	0.50	2.90	n.a.
May-12	**(**)**									
Retail Sales	m/m	0.58	-0.30	1.23	-0.80	1.18	1.26	2.94	1.86	1.66
	q/q	-0.95	0.73	-1.12	-1.02	-2.15	0.08	-2.25	-1.89	0.34
					Labor Market					
May-12	**(***)**									
Unemployment rate	Level	11.10	5.60	10.10	10.10	24.60	8.10	15.20	21.90	14.60
	Change	0.10	0.00	0.10	-0.10	0.30	0.00	0.00	0.50	0.00
Mar-12										
Labour costs	TLC q/q	0.28	n.a.	-0.09	0.36	0.18	-2.38	0.67	n.a.	n.a.
	ULC q/q	0.37	0.94	0.26	0.43	-1.38	1.45	-1.81	n.a.	n.a.
					Prices					
May-12										
HICP	m/m	-0.10	-0.20	-0.10	0.00	-0.20	n.a.	-0.30	-0.30	0.00
	y/y	2.40	2.20	2.30	3.50	1.90	2.80	2.70	0.90	1.90

Notes: (*) for Germany data is for May,
(**) for Greece and Italy data is for April,
(***) for UK and Greece data is for March
Note: Blue colour: improvement. grey: deterioration. white: neutral
Note: quarterly figures are averages
Source: Eurostat, European Commission and BBVA Research

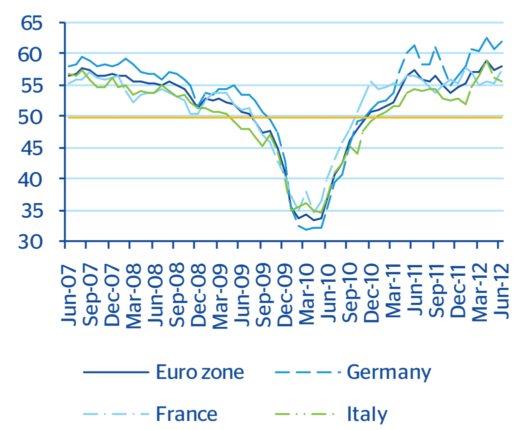
Tabla 2
Eurozone countries : comments on main indicators

Country	Comments
Country	Comments
Eurozone	After contracting in Q4, economic growth remained flat in Q1-2012. In recent months, industrial production fell, with a rebound observed in May (+0.6%), while new orders were positive only in March (+2%) during 2012. Soft data points to a clear deterioration in confidence. ESI confidence deteriorated for a third month in a row in June (-0.6p), while PMI indices remained all in contraction, though services index improved by 1.9p. Private consumption is volatile, as retail sales data indicates, and after an overall improvement during Q1, they fell by 0.2% on a 3mma basis to May. Inflationary pressures have eased (1.4% in May-June), but unemployment rose to 11% in March-April and to the record high of 11.1% in June. **EC forecast (May 2012)|2012: -0.3% , 2013: 1.0%**
Germany	Economy contracted less than expected in Q4-2011 and rebounded with a GDP growth of 0.5% q/q in Q1-2012. Industrial production is following a positive trend during the first five months of the year, with the exception of April (-2.0%), but PMI indices are both in contraction in June, with manufacturing below and further down from 50 during March-June and services entering contraction only in June. Confidence is trending downwards since March: economic sentiment reached the long-term average in June and consumer sentiment deteriorated in April and June (by -1.7p each month), with an improvement of 2.7p in May. Retail sales are also falling, but at low rates. Unemployment is low and remains flat since November 2011 (at 5.6%). Inflation reached the target rate, with HICP at 2.0% y/y in June (CPI at 1.7%). **EC forecast (May 2012)|2012: 0.7% , 2013: 1.7%**
France	It avoided contraction and stagnated both in Q4-2011 and Q1-2012. The industrial sector is deteriorating, with industrial production falling by 0.6% in Q1 (latest data in May: -2.1%, while new orders improved by little less than 1% (and a 3% growth in April). Confidence is deteriorating in all sectors during Q2, except for consumer sentiment, where it gained 3.6p in the last three months to June. PMI in Services was in contraction during each month of Q2, but it improved significantly in June (+2.8p). PMI manufacturing gained significantly in February reaching the stability level of 50, but it fell back in contractionary territory in March and in June it improved slightly (+0.5p). Unemployment rate was at 10% for four months, before increasing by 0.1pp in May. On the external front, both imports and exports have been growing, except for March, with imports falling much stronger than exports. **EC forecast (May 2012)|2012: 0.5% , 2013: 1.3%**
Italy	Economic activity continued in recession, as the economy contracted for a third quarter in Q1-2012 (-0.8% q/q). Industrial production improved in May, but during the last three months it lost -0.1%, while new orders, with the exception of a strong rebound in March, have been trending downwards through 2012 so far. ESI confidence data suggests that sentiment improved in June, after two months of deterioraion. Both PMIs remain in contraction, but services improved and manufacturing fell in June (+0.4p and -0.2p respectively). Retail sales improved in May (1.2% m/m)., after falling for three consecutive months. Unemployment slightly dropped in May to reach the level of March (at 10.1%) and inflationary pressures eased (HICP 3.5% in May, CPI at 3.3% in June). Exports and imports of goods are both improving except for April, with exports in general growing more than imports. **EC forecast (May 2012)|2012: -1.4% , 2013: 0.4%**
Spain	GDP contracted for two consecutive quarters, by 0.3% q/q each. Industrial production was trending downwards during 2012 so far, with only May figure showing a growth, of +0.9% and new orders lost 1.5% the last three months (3mma). PMI manufacturing and services remain in negative territory, but the services sector in June gained some points (+1.5p to 43.4). On consumption, retail sales, rebounded in May, gaining 1.2% m/m, in line with improving consumer confidence, but unemployment is at extremely high levels (24.6%, the highest rate in Eurozone and +0.3pp in just a month). ESI general indicator rebounded after having fallen for four months. Inflation has slowed to 1.9% y/y in May-June. Externally, exports are stronger than imports and they both fell only in April. **EC forecast (May 2012)|2012: -1.8% , 2013: -0.3%**
Ireland	Ireland remains the best performer compared to the rest periphery. After meagre growth in Q4, GDP fell by 1.1% in Q1-2012 (mainly due to one-offs). Industrial production has been trending upwards since March, after a sharp fall in February (-3.0% m/m), but new orders have been deteriorating, except for March. In April alone, they fell by 4%. Retail sales improved in May (+1.7% m/m) after a milder fall in April. Unemployment is high (at 14.6%), but remained stable after easing in April. There are no concerns about inflation, which stands below the target, though at levels higher than those observed in the beginning of 2012. On the external side, exports and imports follow a zigzag pattern, with imports falling, but also rising stronger. **EC forecast (May 2012)|2012: 0.5% , 2013: 1.9%**
Greece	Economy is in deep recession since 2008 and most probably will stay there for at least 2 more years. There is a declining trend most indicators, but industrial production slightly rebounded in April and May, while new orders fell stronger, by 2.6% in April. PMIs remained in contraction during 2012 so far, with only some improvement in services during June. ESI confidence is declining, but consumer confidence has been steadily improving. Unemployment is nevertheless growing exponentially, reaching 22.5% in April and will remain a concern in the future. Inflation is falling (HICP 1% in May), due to decreasing activity and strong austerity that restrains domestic demand. Finally, the external sector is improving, as exports are growing faster than imports. **EC forecast (May 2012)|2012: -4.7% , 2013: 0.0%**

Source: BBVA Research

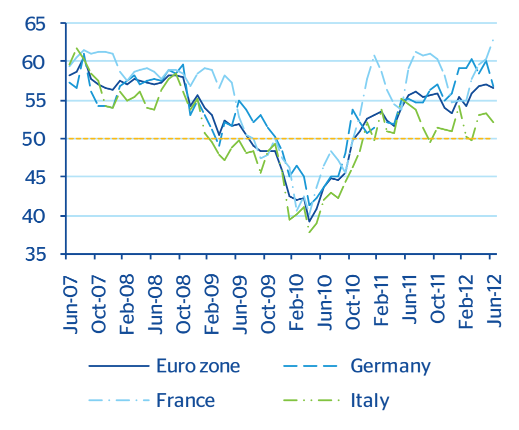
PMIs: Remain in contractionary territory, for fifth month, but some improvement in June

Chart 1
Countries: Markit PMI Manufacturing Index



Source: Markit Economics

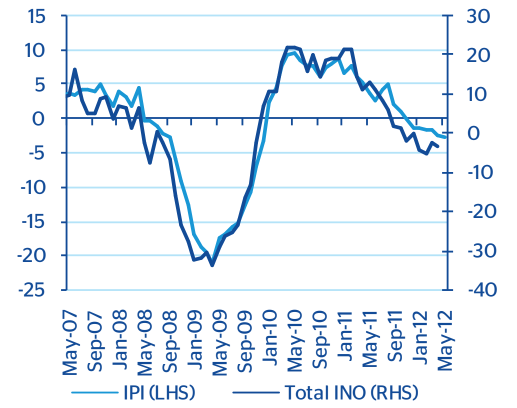
Chart 2
Countries: Markit PMI Services Index



Source: Markit Economics

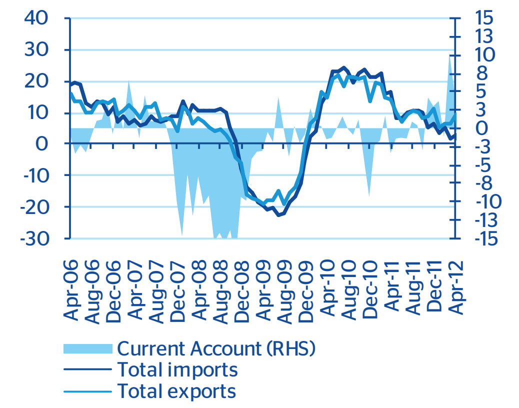
Downward trend in industrial activity halted in May, while external balances improved further

Chart 3
Eurozone: Industrial sector (%y/y)



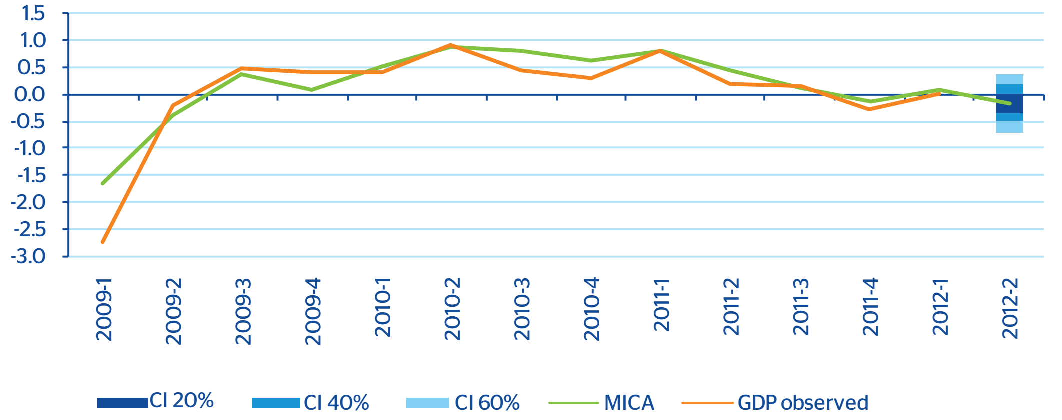
Source: Eurostat and European Commission

Chart 4
Eurozone: Industrial new orders and production(%y/y)



Source: Eurostat & BBVA Research

Chart 5
MICA and GDP observed (% q/q)



Source: BBVA Research

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