Global

Weekly Watch

Madrid, 23 July 2010

Economics Analysis

Financial Scenarios
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Stress tests in Europe and the Federal Reserve on a slower path

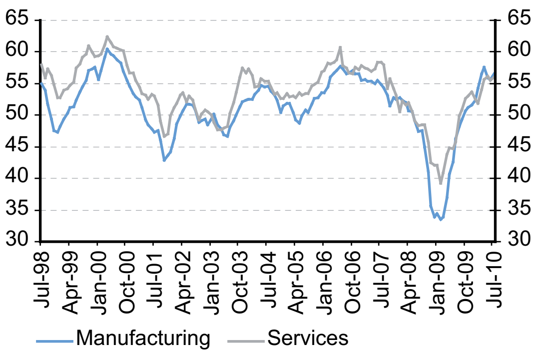
The widening gap between US and EMU events became even clearer this week. In Europe, macro data came surprisingly high in July's PMI, but the main concern was obviously on the stress tests and their implications. The combination of "less bad" macro data and a powerful stress test is precisely what saved the US back in 2009.

This time around, however, on the other side of the Atlantic the focus remains on the much feared double dip. Bernanke's remarks on his Congress appearance corroborated that the Fed shares the view that risks are increasing. Bernanke refrained from saying what measures the Fed might take if a sharper slowdown were to happen, but his "greater than normal" uncertainty is clearly a reason to expect a more cautious Fed. We are revising our Fed forecast and now expect gradual increases in the funds rate in the third quarter of 2011.

…and the first signs of diverging monetary policy in emerging markets

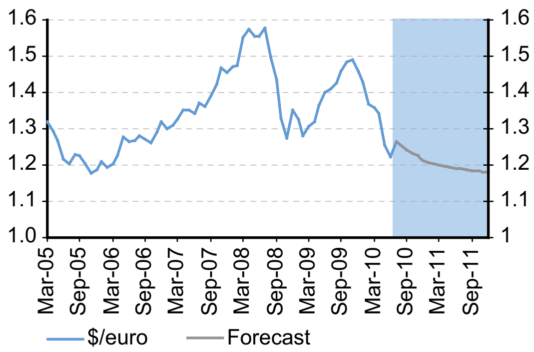
Brazil's central bank decision to hike by 50bp (instead of 75bp) and Banxico's recent action suggests some countries in Latin America are aware of the convenience of not raising too early or too fast. In Asia, however, strong growth (as we expect in Korea next week) is still putting pressure to continue tightening.

Chart 1
Eurozone: PMI survey



Source: Markit Economics

Chart 2
Euro-dollar exchange rate and forecast (monthly average)



Source: BBVA Research

Highlights

Federal Reserve is expected to raise rates in 3Q11

Given the more uncertain outlook and low risk of inflation, the Fed will maintain low rates for a prolonged period of time. BBVA Research has pushed back its baseline forecast for the first fed funds rate hike to 3Q11 from 1Q11.

Will the euro appreciate further? Medium-term views on the euro-dollar rate

The euro has recently recovered much of the ground lost against the USD, but we consider recent euro strength a temporary factor, and our call is for a strengthening of the dollar in the medium-term.

Brazil: Moving towards a softer monetary tightening cycle in Brazil

The Central Bank adjusted the SELIC up by 50bps to 10.75%. This decision consolidates the view that monetary tightening cycle in Brazil is going to be softer than expected.

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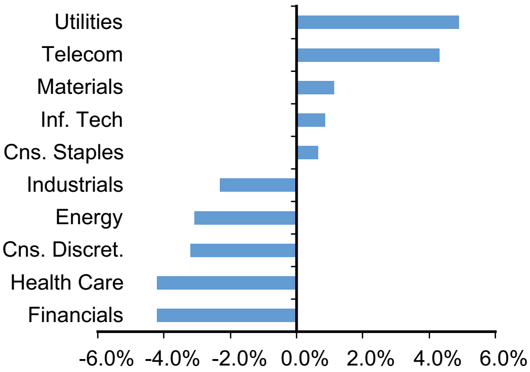
Doubts over the economic cycle are being reflected in sector performance on equity markets

In the US doubts over the economic cycle are being clearly reflected in the sector performance of the S&P 500. Unlike previous months when there was little distinction between cyclical and defensive sectors, since doubts centred on financial risk, now during the sessions of falls in equity the best performing sectors have been Food & Beverage, Tobacco, Utilities and Telecoms. The important point is that, if we are really heading for a double-dip and not just a slowdown during the recovery phase which is our view, the sectors that have traditionally been defensive will act as market safe havens as they have during previous crises. Until now the debate was focused on the financial strength of countries and their financial systems, a scenario in which "there are no safe havens".

However, the sector trend in Europe is not as clear, because the debate is still on another issue (financial/sovereign risk, stress tests), and cyclical and defensive sectors are all bunched together during falls in equity.

Chart 3

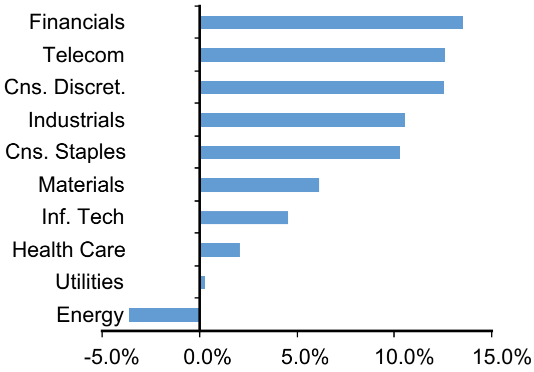
S&P 500 Economic Sector performance 5/7/2010-7/23/2010. (USD)



Source: BBVA Research

Chart 4

S&P350 Europe Economic Sector performance 5/7/2010-7/23/2010. (EUR)



Source: BBVA Research

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Highlights

Federal Reserve is expected to raise rates in 3Q11

BBVA Research has pushed back its baseline forecast for the first fed funds rate hike to 3Q11 from 1Q11. Recent economic trends indicate that substantial economic slack remains and the pace of growth is going to ease in the second half of the year. The employment situation could remain a drag on economic growth and is likely to play a large role in Fed policy decisions. While the labor market is improving, the tempo is not sufficient to result in a marked improvement in the unemployment rate. Furthermore, new risks have emerged due to the EU's sovereign debt problems, which have added substantial uncertainty to the financial markets and economic outlook. In addition, inflation expectations are well anchored and core inflation is expected to remain subdued through 2012. Given the more uncertain outlook and low risk of inflation, the Fed will maintain low rates for a prolonged period. In addition, if downside risks increase further, the Fed could re-start quantitative easing measures in order to assure financial stability.

Will the euro appreciate further? Medium-term views on the euro-dollar rate

The euro has recently recovered much of the ground lost against the USD and reached again the $1.30 level. Are we seeing a resurgence of the euro with room for further appreciation? Or is this recent movement not expected to last? We think that this second alternative is more probable. The recent euro appreciation is a clear result of less fear regarding the Eurozone crisis and, in particular, the Spanish situation, specially after the successful Spanish debt auctions; as the previous fast dollar appreciation was a clear symptom of market uncertainties about the resolution of the European crisis. Also, recent negative surprises in US data weighed on the dollar. However, is still to soon to consider that European debt crisis is over; stress test results this afternoon are key on this theme. But even if risk aversion considerations recede, we think that fundamentals will increasingly sustain the USD. Not only growth perspectives are better for the US and financials risk is higher in the EMU, which implies that there will be formerly monetary policy normalization in the US, but also the Eurozone is embraced in earlier fiscal consolidation; all factors that tend to weakens the common currency. In sum, we consider recent euro strength a temporary factor, and our call is for a strengthening of the dollar in the medium-term.

Brazil: Moving towards a softer monetary tightening cycle in Brazil

On Wednesday, the Central Bank adjusted the SELIC up by 50bps to 10.75%. In the previous two monetary policy meetings the adjustments had been by 75bps. The slowdown in the pace of the tightening is related to a recent moderation in both growth and inflation figures and also to concerns about global growth. The monetary authority decision consolidates the view that monetary tightening cycle in Brazil is going to be softer than expected. Just some weeks ago many expected the SELIC to be in the 12%-13% range by the end of the year. At this point, even our 11.75% call can be seem as hawkish. Risks are clearly tilted to the downside. The minutes of this week's meeting, to be released next week, should give us more information about future monetary decisions.

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Calendar: Indicators

USA: Real GDP (qoq annualized) (2Q10, July 30th)

Forecast: 3.2%	**Consensus:** 2.5%	**Previous:** 2.7%

Comment: The economy is expected to expand at a faster pace in the second quarter than in the first. Fiscal stimulus and inventories continue to support economic growth, but private demand is taking hold as well. Business investment in equipment and software strengthened in 2Q10, but consumer spending grew at a slower rate. **Market Impact:** A negative surprise in second quarter growth would indicate significant weakness in the economy and increase the debate about the necessity of additional fiscal stimulus.

USA: Consumer Confidence (July, July 27th)

Forecast: 52.4	**Consensus:** 52.0	**Previous:** 52.9

Comment: Consumer confidence is expected to drop in July and remain close to the average that it has maintained for over a year. Even though the employment situation has begun to improve, households remain concerned about its slow pace of recovery. **Market Impact:** A slowdown in consumer confidence would support our expectation that the pace of growth of consumer spending will slow in the second half of the year. Consumers are waiting to see a faster pace of hiring and more certainty in the economic outlook.

Eurozone: Inflation flash estimate (July, July 30th)

Forecast: 1.6% y/y	**Consensus:** 1.8% y/y	**Previous:** 1.4% y/y

Comment: We expect headline inflation to accelerate again in July by around 0.2pp, although with high uncertainty given the sales effect and the VAT hike in Spain, which should be transferred to consumer prices more moderately than in past such changes due to the weakness of private consumption. The flash estimate does not provide information about core inflation, for which we forecast a stable rate. **Market Impact:** A negative surprise could significantly affect markets, which can read it as a further deterioration in consumers' confidence and spending.

Eurozone: Unemployment rate (June, July 30th)

Forecast: 10%	**Consensus:** 10%	**Previous:** 10%

Comment: Unemployment is expected to have remained broadly stable in June, as observed since early this year, supported by the rebound of economic activity in Q2. However, the trend of unemployment is to increase slightly over the second half of the year (by around 0.3pp), in line with our scenario of a weak economic growth. **Market Impact:** An increase of unemployment rate to 10.1 is also possible and would be interpreted as a sign of renewed downward pressures in economic activity, with negative effects on economic confidence.

Korea: GDP growth (2Q10, July 26th)

Forecast: 6.7% y/y	**Consensus:** 7.1%	**Previous:** 8.1%

Comment: Given robust external demand, a recovering labor market and rising consumer confidence, we expect growth momentum in Q2 to be strong. **Market Impact:** a higher-than-expected GDP outturn could increase expectations of further interest rate hikes, following the BOK´s first hike in the current tightening cycle earlier this month. Nonetheless, stronger GDP growth would be interpreted positively as a sign of strength in the global economy, despite expectations of a slowing H2 in Korea and elsewhere in Asia.

Mexico: IGAE, May (July 27th)

Forecast: 0.2% m/m	**Consensus:** n.a.	**Previous:** 1.0%

Comment: against April's evolution, industry and services would support monthly activity indicator. Released figures from car production (2.9% m/m vs 0.8% m/m average Jan-April) and slightly better retail sales evolution, are positive signals on GDP growth in 2T10. **Market Impact:** high volatility and some delay respect reference date limit the IGAE's impact on markets, but considering the market sensitiveness to cycle related figures, a negative surprise on Mexican growth would have an effect on markets.

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				Close	Weekly change	Monthly change	Annual change
Interest Rates	(changes in bps)	US	3-month Libor rate	0.49	-3	-4	-1
			2-yr yield	0.56	-2	-12	-43
			10-yr yield	2.95	2	-19	-71
		EMU	3-month Euribor rate	0.89	2	14	-4
			2-yr yield	0.75	-2	22	-57
			10-yr yield	2.70	9	10	-78
Exchange Rates	(changes in %)	Europe	Dollar-Euro	1.284	-0.6	3.9	-9.7
			Pound-Euro	0.83	-1.1	1.0	-3.5
			Swiss Franc-Euro	1.35	-0.4	-0.5	-11.0
		America	Argentina (peso-dollar)	3.93	-0.1	0.1	3.2
			Brazil (real-dollar)	1.76	-1.2	-1.3	-6.9
			Colombia (peso-dollar)	1863	-0.9	-1.5	-5.5
			Chile (peso-dollar)	520	-2.0	-3.4	-3.6
			Mexico (peso-dollar)	12.78	-1.3	0.9	-3.4
			Peru (Nuevo sol-dollar)	2.82	0.0	-0.1	-5.7
		Asia	Japan (Yen-Dollar)	87.36	0.8	-2.1	-7.9
			Korea (KRW-Dollar)	1198.63	-1.4	0.1	-4.1
			Australia (AUD-Dollar)	0.893	2.6	2.8	9.3
Comm.	(chg %)		Brent oil ($/b)	77.2	2.4	0.9	9.8
			Gold ($/ounce)	1191.0	-0.2	-4.2	25.2
			Base metals	474.4	1.0	-1.4	11.8
Stock Markets	(changes in %)	Euro	Ibex 35	10278	2.9	7.2	-1.5
			EuroStoxx 50	2703	2.2	2.2	4.7
		America	USA (S&P 500)	1092	2.6	1.7	11.6
			Argentina (Merval)	2360	3.4	2.6	40.9
			Brazil (Bovespa)	65705	5.4	2.8	20.7
			Colombia (IGBC)	13221	2.3	5.8	28.5
			Chile (IGPA)	19972	2.1	5.8	29.8
			Mexico (CPI)	32616	2.6	0.9	22.4
			Peru (General Lima)	14091	1.3	-0.2	1.8
			Venezuela (IBC)	64294	-0.7	-0.5	40.9
		Asia	Nikkei225	9431	0.2	-5.0	-5.2
			HSI	20815	2.8	0.4	4.2
Credit	(changes in bps)	Ind.	Itraxx Main	115	-3	-14	19
			Itraxx Xover	515	-20	-44	-137
		Sovereign risk	CDS Germany	41	1	-2	11
			CDS Portugal	275	-12	-48	219
			CDS Spain	203	-17	-62	138
			CDS USA	37	1	0	---
			CDS Emerging	234	-12	-29	-110
			CDS Argentina	849	-73	-124	-971
			CDS Brazil	120	-6	-14	-25
			CDS Colombia	128	-8	-25	-52
			CDS Chile	90	-4	-9	-8
			CDS Mexico	121	-6	-11	-53
			CDS Peru	114	-7	-19	-44

Sources: Bloomberg, Datastream and JP Morgan

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