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Weekly Watch
Global

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Economic Analysis

Financial Scenarios
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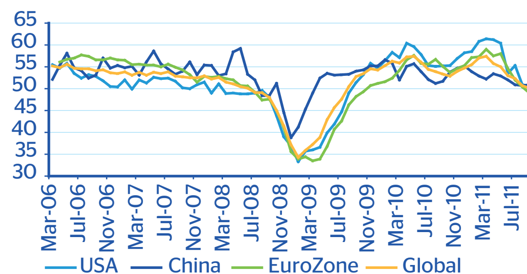
Global growth concerns deepen

Anxiety increased this week after the US employment report hit recovery hopes: the US economy did not create any jobs in August. It was a much worse than expected jobs report. Only 17K net private jobs were created, the weakest outturn since the economy began to add jobs in the current cycle (since March 2010). This week also brought further signs of a slump in global manufacturing activity. However, the slower pace of deterioration in August points to a less pessimistic outlook than feared (with the exception of the EZ). PMIs have been falling for several months, suggesting that: things are getting worse. The Global PMI, compiled by JP Morgan, declined for the sixth consecutive month to 50.1 in August from 50.7 in July, reaching its lowest level since July 2009, and staying just barely above the 50 threshold which separates expansion from contraction. Data in the US and China came out better than expected: the US ISM index did still fall, but declined less than anticipated and stayed above 50 (50.6), while China's PMI was slightly below expectations, but rebounded modestly to 50.9, following consecutive slips for four months (from 53.4% in March to 50.7% in July), and in our view it continues to point to a soft landing scenario. More worrying were the PMI figures for the EZ: final manufacturing PMI was reported to have fallen by 0.7 points more than in the flash estimate, taking the headline composite reading below 50 (down to 49.0), signalling contraction for the first time since September 2009.

Fed action likely in September; ECB to shift to a neutral stance

As a result of increasing downside risks to activity, significant reactions from central banks are likely to come in September. Minutes released On Wednesday from August's FOMC meeting were more dovish than expected and showed that the bias towards additional action is growing (see highlight). Given that those favouring further easing (a 7-3 majority?) considered the change in the forward guidance (i.e. the pledge to hold rates until mid-2013) a "measured response", additional accommodative measures are likely if the economic outlook deteriorates further. Possibly, the outlook did just that on Friday after the jobs report was released. The most likely move by the FOMC at the September 20-21 meeting is to announce a lengthening of the average maturity of the Fed's balance sheet. Meanwhile, Mr. Trichet's comments before the European Parliament on Monday marked a significant shift away from the ECB's recent rhetoric and appeared to pave the way for a neutral tone in next week's Introductory Statement to the ECB's regular monthly meeting (see highlight). Meanwhile, central banks in emerging countries are continuing to shift their focus from inflation to growth: in an unexpected movement, the Brazilian CB cut its reference interest rate (SELIC) by 50bp to 12.0%, after hiking it by 25bps at the last meeting in July.

Chart 1
Manufacturing slowdown in Purchasing Managers' Index



Source: Bloomberg and BBVA Research

Chart 2
ISM & New Orders Less Inventories

Source: Bloomberg and BBVA Research

Highlights

Fed: Bias towards action growing
FOMC minutes show more willingness from the Fed to ease.

ECB signals readiness to pause
Mr. Trichet's comments marked a significant shift away from the ECB's recent rhetoric.

China: Broadening of reserve requirements amidst a robust PMI outturn
With activity indicators pointing to robust growth momentum, the move is understandable.

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Markets

The difficulties European banks are encountering in obtaining funding in dollars are pushing up Libor/Ois spreads

The performance of the spreads which have traditionally been used to measure financial risk – namely the Libor/Ois – is reflecting different profiles in the US and Europe. Although both have increase since the end of June, Europe has risen considerably more since the Ois (in this case Eonia) has dropped, reflecting expectations of excess liquidity over a very long period and a probability of cuts to rates. In the US the movement has been much more moderate (see chart) and has primarily come from the widening of the Libor (since rates are anchored at zero, the downside for the Ois is limited). It is important to note that this widening of the Libor is being caused by the difficulties that foreign banks are having in obtaining funding in dollars, especially European banks, due to concerns over their exposure to the sovereign risk crisis

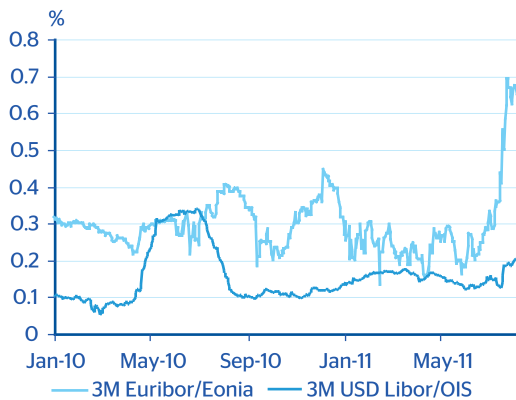
Stock markets closer to technical supports

In our opinion, something else is necessary for the technical rebound to become a bull rally since underlying problems are still there: European banks continue to face sovereign and financing risks (which is why the ABE has proposed to authorise banks to issue EU-backed bonds) and the uncertainty surrounding the extent and duration of the global slowdown and the cutback on 2012e EPS is increasing. We would closely watch implied volatilities: as long as the VIX (S&P-500) and the V2X (EuroStoxx-50) indices remain well above 25 and 30 vegas respectively, we would maintain a cautious stance on stock markets.

Investors give credit markets a breather after the sharp widening in August

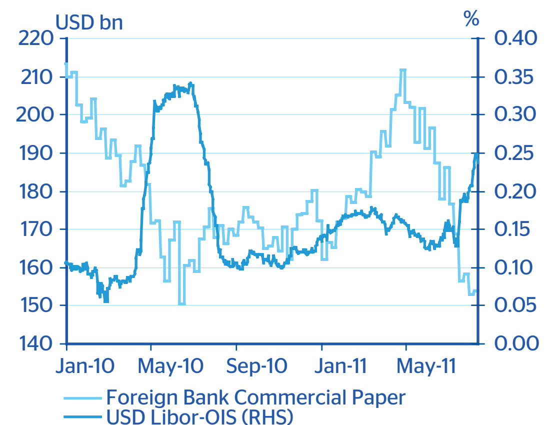
After the sharp widening in August, in which credit markets registered their worst performance of the last three years, there has been a brief respite and credit spreads have tightened slightly. Despite the fact that the month has started out stronger, overall market sentiment is far from positive. Investors remain cautious as they await solutions for the three main factors in Europe that are generating uncertainty: i) the European sovereign crisis, which is not only exclusive to the periphery countries, ii) the unfolding of the second bailout of Greece, iii) the delay in the rollout of the new functions of the EFSF. In the week to date there has been a generalised tightening of spreads in the synthetic indices.

Chart 3
3M Libor - Ois spreads, Us and Europe



Source: Bloomberg and BBVA Research

Chart 4
Volume of foreign banks' CP and L-Ois sptread



Source: Bloomberg and BBVA Research

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Highlights

Fed: Bias towards action growing

FOMC minutes described a deteriorating recovery in the US, lowering notably its forecasts and painting a morose picture of current conditions. In particular, the state of the economy leaves it vulnerable to shocks, which may arise from European sovereign debt issues, unfolding US fiscal austerity, and household financial conditions. On the other hand, high resource slack will contain any inflation fears for a considerable time. The FOMC discussed possible tools for implementing more accommodation at this stage: lowering the interest on excess reserves, lengthening the average maturity of the SOMA, use of more forward guidance, and possibly tying decisions to a numerical inflation or unemployment rate. Despite some FOMC members' beliefs that monetary policy may be ineffective in combating long-term rigidities, the minutes show more willingness to ease from the Fed, although we think they are not sure at present about which tool will pack the best value for money. Given the easing camp felt that the use of forward guidance was a measured step towards more aggressive easing, we can expect more accommodative measures if economic conditions deteriorate further.

ECB Signals readiness to pause

The ECB now seems to be re-evaluating policy in light of recent events, as it made a number of wording changes that made the most recent overall statement less hawkish. Although the changes in the tone were significant, the ECB did not soften its remarks that the risks to price stability "remain on the upside"– i.e. the only certain implication was that (at least) the pace of hikes (one every three-months) would slow down. However, a worsening outlook for growth suggests that the ECB has little reason to expect inflationary pressures in the near future. Mr. Trichet's comments before the European Parliament on Monday marked a significant shift away from the ECB's recent rhetoric and appeared to pave the way for a neutral tone in next week's Introductory Statement to the ECB's regular monthly meeting (September 8). The key change is that the ECB is reassessing inflation risks: Mr. Trichet said that inflation risks were "under study" rather than "on the upside". Moreover, the phrase that monetary policy "remains accommodative" was not brought up. These are major changes if we recall that ECB's communication over the past months was increasingly giving the impression that the two hikes were not only pre-emptive moves but rather the beginning of a rate "normalisation" cycle (the economic outlook was not as supportive for engaging on such a path, but it seemed that it was the ECB's desire judging by its messages). Mr. Trichet seems to be paving the way to make a shift to a more neutral assessment of inflation risks and thus signal a readiness to pause. This, together with a worsening outlook (revisions to the ECB staff macroeconomic projections will also be unveiled on 8 September) implies that the ECB will most likely embark on a monetary policy pause that could be prolonged considering that staff projections for both growth and inflation are likely to be lowered significantly. It is our view that by doing that, it would signal a "wait and see mode".

China: Broadening of reserve requirements amidst a robust PMI outturn

Against a backdrop of growing downside risks to the global economy, the latest (August) reading of the Manufacturing Purchasing Managers Index (PMI) shows that China's economy remains resilient. In particular, the PMI ticked up for the first time in four months, to 50.9% from 50.7% in July, within the 50+ expansion zone. The rebound reflects steady industrial production and robust domestic demand. While the outturn was slightly below expectations (Consensus: 51.0%; BBVA: 51.4%), and new export orders fell due to weakening external demand, it should nevertheless help bolster confidence in China's growth momentum. Separately, early this week the authorities were reported to have broadened the base for calculating banks' required reserve ratios, amounting to an effective tightening of 100-130bp in the RRR. The specific move, to be phased in over six months, is to include banks' margin deposits in the calculation, which has been interpreted by the market as an effort by the authorities to clamp down on credit extended through bankers' acceptances and other such loopholes. It came as somewhat of a surprise as many observers had not expected further monetary tightening measures given the rise in global uncertainties. However, with activity indicators pointing to robust growth momentum and inflation having reached a high of 6.5% in July, the move may be understandable, and in line with our previous expectations of another hike in the RRR and one more interest rate hike.

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Calendar: Indicators

Eurozone: Retail sales (July, September 5th)

Forecast: -0.3% m/m	Consensus: -0.1% m/m	Previous: 0.7% m/m

Comment: we expect retail sales to have declined further at the beginning of Q3, as high uncertainty over the economic outlook combined with high unemployment rates weighed on consumers' sentiment. These figures mean that retail sales should remain below Q2 levels, while recent soft data does not reveal any positive sign pointing to a clear recovery in household spending in the rest of the quarter. **Market impact:** despite the high volatility of this series, a sharp fall in retail sales could be read as further evidence of another quarter with very weak growth, increasing fears about a double-deep in the eurozone.

Eurozone: GDP 2nd estimate (Q2, September 6th)

Forecast: 0.2% y/y	Consensus: 0.2% y/y	Previous: 0.8% y/y

Comment: we expect quarterly GDP growth to be confirmed at 0.2% q/q, slowing considerably from 0.8% q/q in Q1. More relevant news will come from the detailed breakdown of GDP, which is not likely to be very satisfactory, as national data, especially from Germany and France, suggest that private consumption in the eurozone could have slowed in Q2 more than previously anticipated and that the small growth figure could be explained to a great extent by an unexpected accumulation of stocks. In addition, trade balance data point to a marginal contribution of exports to quarterly growth. Overall, we continue to see still robust external demand as the main driver in the eurozone activity, and the key support for investment. **Market Impact:** disappointing figures on growth should increase market fears about the fragility of the recovery, as global demand is expected to slow further, while domestic demand does not take the lead of the recovery.

US: ISM Non-Manufacturing Index (August, 6th)

Forecast: 51.5	Consensus: 51.2	Previous: 52.7

Comment: the ISM Non-Manufacturing Index is expected to decline slightly in August for the third consecutive month as the economy struggles to maintain a strong recovery. Declining consumer confidence and increasing uncertainties regarding the business outlook likely put a damper on service activity for the month. Despite weak labor market growth, service employment continues to outperform other sectors. Thus, it is likely that the index will continue to indicate increasing economic activity, although at a slower pace. **Market Impact:** a larger-than-expected decline in the index will increase concerns of a slowing recovery and warrant negative market reactions.

US: International Trade Balance (July, 7th)

Forecast: -$54.0B	Consensus: -$50.0B	Previous: -$53.1B

Comment: continued weakness in the global economy likely contributed to a widening of the trade balance for July. Export expansion in the service sector has slowed, and concerns of sluggish growth and activity in global markets likely impacted external demand. Auto imports are expected to rebound now that supply chain disruptions from the Japanese earthquake have faded. Furthermore, rising import prices in July likely inflated the value of imports. Thus, we expect reduced exports and increased imports to contribute to a modest deterioration of the trade balance. **Market Impact:** the lagged trade balance report usually attracts little attention from markets, however a large deterioration could have significant implications for 3Q11 GDP.

China: August inflation (Sept 9th)

Forecast: 6.1% y/y	Consensus: 6.1% y/y	Previous: 6.5% y/y

Comment: we expect inflation to ease after having peaked in July, on moderating food prices and favourable base effects. That said, the August outturn is likely to remain well above the authorities' comfort level as inflation pressures persist, causing the PBoC to keep a close eye on liquidity. Looking forward, we expect inflation to fall further during the rest of the year, providing room for possible stimulus measures, if needed, in light of global uncertainties. **Market impact:** a higher-than-expected inflation outturn could reignite expectations of another rate hike, which have recently diminished due to slowing growth and heightened global uncertainties.

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			Close	Weekly change	Monthly change	Annual change
Interest Rates (changes in bps)	US	3-month Libor rate	0.33	1	6	4
		2-yr yield	0.20	1	-13	-31
		10-yr yield	2.06	-13	-57	-64
	EMU	3-month Euribor rate	1.54	0	-6	66
		2-yr yield	0.53	-13	-52	-12
		10-yr yield	2.01	-15	-40	-35
Exchange Rates (changes in %)	Europe	Dollar-Euro	1.421	-1.8	-0.6	10.3
		Pound-Euro	0.88	-0.9	0.7	5.2
		Swiss Franc-Euro	1.11	-4.7	1.5	-15.1
	America	Argentina (peso-dollar)	4.24	1.4	2.3	7.6
		Brazil (real-dollar)	1.64	2.1	4.6	-5.1
		Colombia (peso-dollar)	1783	-0.6	0.6	-1.4
		Chile (peso-dollar)	460	-1.3	0.2	-7.2
		Mexico (peso-dollar)	12.38	-0.8	4.6	-4.4
		Peru (Nuevo sol-dollar)	2.73	-0.1	-0.5	-2.4
	Asia	Japan (Yen-Dollar)	76.77	0.1	-0.2	-9.1
		Korea (KRW-Dollar)	1061.88	-1.6	0.3	-9.4
		Australia (AUD-Dollar)	1.066	0.8	-0.5	16.4
Comm. (chg %)		Brent oil ($/b)	112.0	0.6	-1.1	46.1
		Gold ($/ounce)	1877.7	2.7	13.0	50.6
		Base metals	571.7	0.7	-3.2	12.1
Stock Markets (changes in %)	Euro	Ibex 35	8460	3.4	-6.4	-20.2
		EuroStoxx 50	2224	1.5	-11.0	-19.0
	America	USA (S&P 500)	1180	0.2	-6.4	6.8
		Argentina (Merval)	2898	0.5	-12.4	19.6
		Brazil (Bovespa)	57239	7.3	2.2	-14.2
		Colombia (IGBC)	13403	1.5	-3.4	-4.7
		Chile (IGPA)	20447	3.4	-1.0	-5.7
		Mexico (CPI)	35430	4.1	2.7	8.7
		Peru (General Lima)	20666	4.4	-4.0	32.7
		Venezuela (IBC)	100138	0.2	8.0	54.0
	Asia	Nikkei225	8951	1.7	-7.1	-1.8
		HSI	20213	3.2	-8.1	-3.6
Credit (changes in bps)	Ind.	Itraxx Main	156	-12	29	51
		Itraxx Xover	653	-63	172	173
	Sovereign risk	CDS Germany	76	-9	7	40
		CDS Portugal	957	-66	-37	658
		CDS Spain	376	-2	-44	153
		CDS USA	51	4	-5	---
		CDS Emerging	268	-30	51	31
		CDS Argentina	800	-31	202	-52
		CDS Brazil	144	-20	28	25
		CDS Colombia	143	-19	30	20
		CDS Chile	96	-10	24	24
		CDS Mexico	142	-21	30	10
		CDS Peru	149	-22	24	41

Source: Bloomberg and Datastream

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