BBVA Research

Global

Weekly Watch

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Economic Analysis

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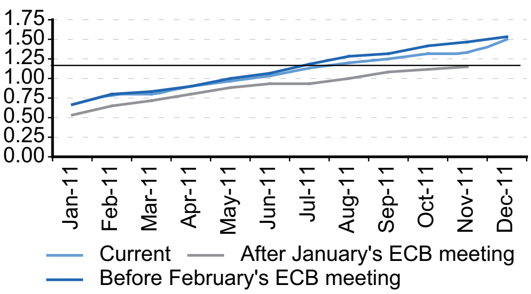
Economic momentum is improving

In the US, domestic demand seems to be gathering momentum as the services index and consumption expenditures showed solid growth again. The payrolls figures released today indicate that the U.S. labor markets remain weak despite strong recovery in 4Q10 and 1Q11, suggesting that the positive trend in domestic demand has not consolidated yet. On the other hand, in the Eurozone there is not clear evidence that foreign demand growth is dragging up domestic consumption, apart from Germany, where increases in employment and in the services index suggest a further improvement in domestic demand. Eurozone retail sales fell again in December, by -0.6%, suggesting a sluggish performance of private consumption at the end of 2010. On the positive side, this factor should prevent a significant extension of commodity prices to other inflation measures, despite the fact that the Eurozone headline inflation flash estimate accelerated in January to 2.4%. In Asia the PMI index showed that manufacturing is expanding but at a more moderate pace in China, while inflation picked up in various countries such as Indonesia, Thailand and South Korea. Concerning geopolitical risk, so far, unrest in Egypt is not having a significant impact on the global risk premium while the main commodities are suffering most of the impact (see highlight).
EU Council meeting has end with vague draft, detailed proposals on EFSF and SDM will be reach (as expected) until end of March. Also, a new element "competitiveness" has been introduced in the debate (Germany and France call for a Eurozone meeting in early March). It could generate some noise in markets.

Central Banks try to calm down debt markets

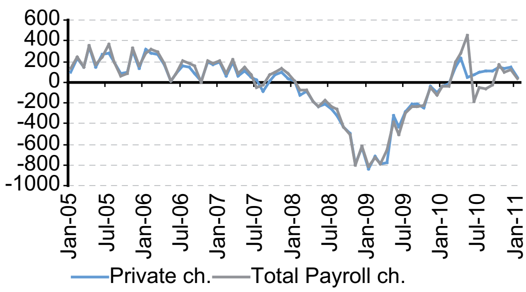
The ECB was cautious and did not want to sound more concerned about inflation. It seems that an ECB rate hike will be unlikely during this year although inflation is likely to remain above 2% for most of the year. On the other hand, Bernanke stressed that it is necessary to see a sustained period of job creation to consider the economic recovery to be truly established. He again defended the Fed's large scale asset purchase plan. He warned that high rates of government borrowing could increase the crowding out effect on investment, and he maintained a soft tone on inflation expectations. Emerging markets have stepped up efforts to curb inflation expectations. Indonesia hiked its main interest rate 25bp while the Bank of Peru increased the minimum reserve requirement and the Bank of Colombia became more hawkish.

Chart 1
Implicit Official Rates in EONIA Futures



Source: Bloomberg and BBVA Research

Chart 2
The US Payroll. Month ch. (k)



Source: Bloomberg

Highlights

Manufacturing activity expands further

Firms are not passing through to output prices; all the increase is in input prices.

Egypt: a reminder of EM sovereign risk

Egypt will put political/institutional risk back into investors' focus.

Key Calendar events regarding European Sovereign risk premium

European peripheral spreads have priced in a positive scenario for a European agreement.

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Markets

The geopolitical premium fuels the rally in commodities

The conflict in Egypt has led to a premium on commodities, in response to the risk of transport through the Suez Canal being affected, which would increase transport costs, should ships have to finish their journey by travelling round Africa. So far, there have been no disruptions on the supply route. In terms of oil, the capacity that could potentially be affected is around 4mb/d, since there is an oil pipeline running alongside the canal.

Some natural phenomena, such as the cyclone in Australia, and the drought in China, are having an impact on supply. North-eastern Australia is suffering from a cyclone which is making it even more difficult to recover the production lost as a result of the recent floods. In this case, the main commodity affected is coal, followed by metals such as copper and aluminium. The three months without rain affecting 12 provinces in Northern China will have an impact on 20% of the wheat produced in the winter.

In view of these events, we cannot rule out rises in the short term, although our medium-term outlook is that as these problems are gradually resolved (primarily the geopolitical issues rather than the meteorological ones), we should see some drops.

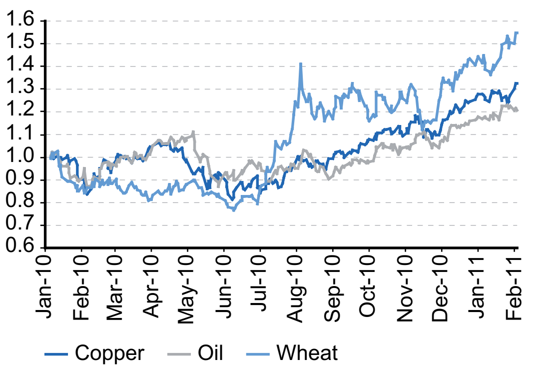
Continued rally in credit indexes

The rally is still the dominant trend in credit indexes, with across-the-board narrowing in corporates and financials, driven by the improvement in investors' perception of "peripheral risk". Recent issues by Iberian corporates have performed well on the secondary market, narrowing by more than 30bps vs. their issue spreads across the board. Domestic financial issuers have also been able to issue with longer durations, for example the recent 5-year covered bond issue by BBVA. Finally, foreign investors have become increasingly involved in this issuance (90%). All of the above leads us to maintain our positive outlook for credit indexes, provided that the sovereign debt markets continue to stabilize.

We anticipate some consolidation on equity markets

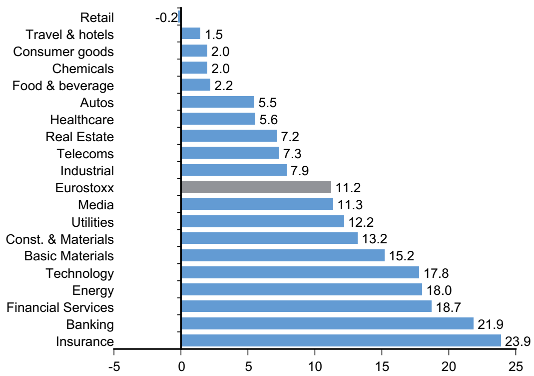
Equity markets have been testing important technical resistances (1.215 for the S&P-500, 3,050 for the EuroStoxx-50, and 11,200 for the Ibex-35) as a result of i) expectation of an agreement on the framework for European rescue mechanisms, and aceleration of the Spanish financial system's reform (leading to the credit market easing, which has been very positive for banks); ii) the strength of commodities (positive for materials and energy), and; iii) the good 4Q10 results that have been published to date (positive for technology and consumption). However, so far they have failed in their attempts to breach these levels. In our view, the rise has happened too quickly, and together with the geopolitical risks and the tightening of inflation rates, this could bring the recent trend to a halt. For all of the above reasons, we expect a period of consolidation in the short term, in which the sectors which have led the rises (Technology, Banking, Materials, Energy…) should lose the most ground in relative terms. In the medium term, we still expect equity to continue to rally.

Chart 3
Performance of Commodities since 2010*



*January 2010 = 1
Source: Bloomberg and BBVA Research

Chart 4
EuroStoxx: Recent Sector Performance



Source: Bloomberg and BBVA Research

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Highlights

Manufacturing activity expands further

PMI indices showed strong readings in the main economic areas in January, especially in the US (to 60.8) while seasonal factors could have led the moderation of China's PMI, which reduces some concerns about overheating in the Chinese economy. In Europe, it is interesting to highlight a reduction of Eurozone divergence as peripheral countries experience acceleration unlike the PMI service showed. These countries are benefiting from net export growth. In the US all components of the PMI showed stronger readings, especially new orders. Labor components in the survey signal improvement in employment in the US and Europe. In China, demand-side components, like import orders, continued to show strength. But also, PMI surveys have shown an increase in price pressures, which is a cause for growing concern. In the US, prices paid rose to 81.5, the highest reading for this index since July 2008. In the Eurozone, input prices have achieved levels of 79.2 dragging up slightly output prices, but the outturn is that firms' margins remain contained as the input-output prices spread is widening. Overall, PMI showed not only that activity is continuing to expand in all areas but also that price pressures are increasing.

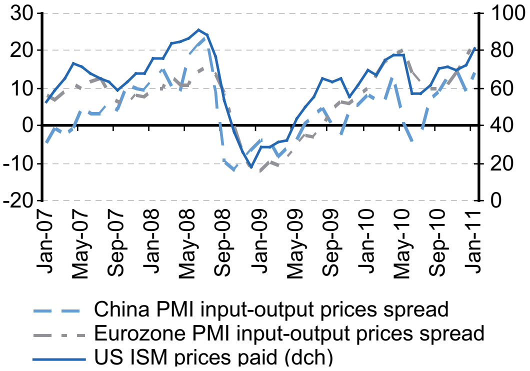
Egypt: a reminder of EM sovereign risk

The propagation of social unrest and more recently outright conflict in Egypt has taken most analysts by surprise. Most observers believed that the Tunisian revolt would only have the effect of maintaining and increasing food subsidies, which is indeed the path taken by most countries with similar problems and was the initial reaction by the Egyptian government. As such, Egypt has become a painful reminder of political risks. Will this have lasting consequences for other emerging markets? In our view, the answer is that it will, but they won't be huge and they need not be bad. As we documented in our 2011 outlook for sovereign risk in EM, it was becoming increasingly apparent in sovereign CDS pricing that investors were demanding too little compensation for institutional risks (the sensitivity of CDS to institutional factors was getting close to 0, according to our model). While we would not advocate putting too much weight on institutional risks (particularly in view of the macroeconomic differences between EM and developed markets), we think this process had gone too far and it is likely that Egypt will put political/institutional risk back into investors' focus. However, this needs not mean a huge increase in premiums: political risk in its most extreme forms is typically associated with autocracies or dictatorships and, fortunately, there have been huge advances towards democratization in most emerging markets. Moreover, if Egypt serves as a catalyst for higher discrimination in markets, this should be welcome. The fundamentals of most EMs are strong enough on their own to withstand higher scrutiny and irrational optimism can only be detrimental over the long term.

Key Calendar events regarding European Sovereign risk premium

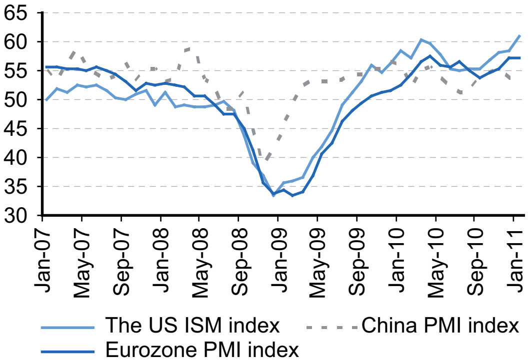
Recent European Sovereign risk premium reduction has encouraged firms and governments to ask for funding in the wholesale market, paving the way for supply pressure. Markets will closely watch the following events: On March 24-25th the EU Council meeting will be held and the market could expect the announcement of a full package of measures that end European countries' funding and solvency problems. The challenge is huge and any disappointment could have a heavy impact on markets. In late June or early July, the European Banks' stress test will be a key event for financial risk as it is expected to be tougher when compared to those released during the summer of 2010. Alongside these two key events, peripheral countries could eventually be a source of volatility: news on the ongoing fiscal consolidation process in Portugal and Spain (in late February Spanish regions' budget executions will be released). Also in Spain, the Decreto ley on the Spanish Financial Sector will be sanctioned, which will provide details on Bank capital requirements and the restructuring process. In addition, there will be elections in Ireland on March 11th, and although the new government will stick to the recently passed Budget Bill we need to know its stance on banks' bail-in.

Chart 5
Input Prices Pressure in Manufacturing



Source: Datastream and Bloomberg

Chart 6
Manufacturing Activity Strengthen



Source: Datastream and Bloomberg

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Calendar: Indicators

Germany: Industrial production (December, February 8th)

Forecast: 0.5% m/m	**Consensus:** 0.2% m/m	**Previous:** -0.7% m/m

Comment: We expect industrial output to have increased further in December, as soft data suggested that the recovery gathered pace at the end of the year, supported by strong export orders. Despite the moderate fall printed in November, industrial output could have grown around 2.5% q/q in Q4 as a whole, suggesting that the slowing observed in Q3 should be temporary. Overall, the industrial sector has registered an impressive growth of around 10% in 2010, recovering from the sharp fall originated over the crisis. Despite upbeat soft data for January, we see a moderation in the pace of the industrial recovery in 2011. **Market Impact:** We think that a very positive surprise could have a larger impact on markets, as along with recent upbeat data could raise expectations of a stronger recovery in 2011.

Germany: Trade balance (s.a.) (December, February 9th)

Forecast: EUR12.3bn	**Consensus:** EUR12.0bn	**Previous:** EUR11.8bn

Comment: The trade balance is expected to have widened slightly in December, as exports could have increased further, while import growth could moderate markedly as a consequence of the sharp rebound in the previous month. Overall, we continue to see net exports as the key driver of the German recovery, although their contribution to growth could be somewhat lower in Q4. **Market Impact:** Very negative figures could raise doubts about the sustainability of a strong recovery in exports and thus about its drag on private demand.

US: Consumer Credit (December, February 7th)

Forecast: USD2.3bn	**Consensus:** USD2.0bn	**Previous:** USD1.3bn

Comment: Consumer credit is expected to increase in December after increasing USD1.3bn in the previous month. However, the total level of credit outstanding will continue to decline (1.8%) on a year-over-year basis due to ongoing contraction in revolving consumer credit. Revolving credits are currently 18% lower than their August 2008 level and are expected to remain depressed in the short-term. We expect consumer credit to increase by USD2.3bn (MoM) in December 2010 to USD2405.3bn. **Market impact:** Although consumer credits are not closely followed by the markets, significant improvement in credit markets would be a good sign for economic recovery.

US: Trade Balance (December, February 11th)

Forecast: -USD39.0bn	**Consensus:** -USD40.5bn	**Previous:** -USD38.3bn

Comment: We expect the trade deficit to increase slightly after contracting for three months in a row. Although exports are expected to increase further due to strong international demand, a surge in oil prices and strong personal consumption in 4Q10 will push imports higher and offset some of the increase in exports. President Obama set a goal for the U.S. economy to double its exports within 5 years and created new incentives for exporters and signed new trade agreements with countries such as China and South Korea. Therefore, we expect U.S. trade balance to shrink in 2011. **Market impact:** Significant contraction in the trade balance would imply bigger contribution of net exports to real GDP growth in 4Q10 and stock markets would welcome the news.

China: Trade Balance (January, February 10th)

Forecast: USD12.9bn	**Consensus:** USD10.2bn	**Previous:** USD13.1bn

Comment: Recent global indicators suggest that prospects for China's major export destinations are improving. Accordingly, we expect China's exports to grow at a rapid pace in January (BBVA: 24.5% y/y, compared to 17.7% y/y in December), although admittedly the export order component of January's PMI was weaker than expected. Meanwhile, with domestic demand still strong, imports are expected to remain high (BBVA: 29.50% y/y, compared to 25.6% y/y in December). As a result, the trade surplus is expected to be around USD12.9bn (nearly the same as in December, at USD 13.1 billion). By comparison, last year's trade surplus amounted to USD183.1bn, an average of USD15.2 per month. **Market Impact:** Strong export growth and/or a larger than expected trade surplus would likely increase international pressure on the authorities to allow faster RMB appreciation.

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Markets Data

				Close	Weekly change	Monthly change	Annual change
Interest Rates	(changes in bps)	US	3-month Libor rate	0.31	1	1	6
			2-yr yield	0.74	20	3	-3
			10-yr yield	3.63	30	16	6
		EMU	3-month Euribor rate	1.09	3	9	43
			2-yr yield	1.43	7	53	44
			10-yr yield	3.26	11	32	14
Exchange Rates	(changes in %)	Europe	Dollar-Euro	1.356	-0.4	2.8	-0.6
			Pound-Euro	0.84	-1.7	-0.7	-3.2
			Swiss Franc-Euro	1.30	1.4	2.3	-11.4
		America	Argentina (peso-dollar)	4.02	0.4	1.2	4.6
			Brazil (real-dollar)	1.67	-0.6	0.0	-11.0
			Colombia (peso-dollar)	1873	0.2	-0.4	-5.9
			Chile (peso-dollar)	478	-1.4	-3.5	-11.8
			Mexico (peso-dollar)	11.98	-1.5	-1.9	-9.1
			Peru (Nuevo sol-dollar)	2.77	-0.3	-1.3	-3.5
		Asia	Japan (Yen-Dollar)	81.93	-0.3	-1.5	-8.3
			Korea (KRW-Dollar)	1101.82	-1.8	-2.0	-6.7
			Australia (AUD-Dollar)	1.016	2.2	1.5	17.8
Comm.	(chg %)		Brent oil ($/b)	101.9	2.5	6.7	46.5
			Gold ($/ounce)	1353.7	1.3	-1.8	27.0
			Base metals	612.7	1.1	5.1	31.5
Stock Markets	(changes in %)	Euro	Ibex 35	10845	0.9	10.7	7.3
			EuroStoxx 50	3006	1.7	6.1	14.2
		America	USA (S&P 500)	1306	2.3	2.3	22.5
			Argentina (Merval)	3638	1.5	0.9	68.0
			Brazil (Bovespa)	65608	-1.6	-7.7	4.5
			Colombia (IGBC)	14791	-1.8	-3.0	31.8
			Chile (IGPA)	21824	-1.9	-7.0	26.9
			Mexico (CPI)	37656	2.2	-2.7	22.9
			Peru (General Lima)	23704	5.2	0.9	70.9
			Venezuela (IBC)	66677	0.9	1.3	15.5
		Asia	Nikkei225	10544	1.8	1.6	4.8
			HSI	23909	1.2	0.6	21.6
Credit	(changes in bps)	Ind.	Itraxx Main	97	-3	-5	6
			Itraxx Xover	408	-11	-9	-88
		Sovereign risk	CDS Germany	56	-5	-1	12
			CDS Portugal	398	-57	-100	174
			CDS Spain	227	-39	-116	67
			CDS USA	47	-3	8	---
			CDS Emerging	211	-14	15	-77
			CDS Argentina	586	-26	29	-489
			CDS Brazil	114	-8	10	-35
			CDS Colombia	115	-8	9	-61
			CDS Chile	77	-9	-5	-3
			CDS Mexico	117	-7	10	-35
			CDS Peru	108	-8	1	-43

Source: Bloomberg and Datastream

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