BBVA Research

Global

Weekly Watch

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Economic Analysis

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Sound Economic data…

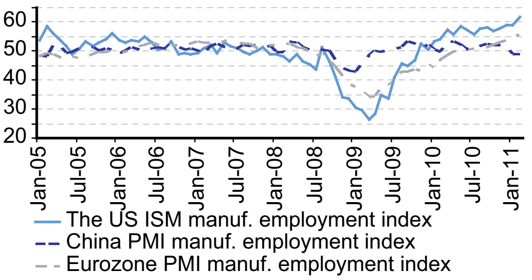
Activity data released this week continued to show a more upbeat outlook at the beginning of the year than previously anticipated in both the US and the Eurozone. In the US, ISM surveys showed that growth is accelerating in the manufacturing and services sectors. Other data also showed an improvement in the US labour market. In Europe, the manufacturing and services PMI suggests that economic momentum picked up in Q1, while January retail sales showed that household spending strengthened in the first month of the year. Nonetheless, the February PMI surveys were compiled in the first half of February, and therefore do no take into account the current spike in oil prices. In Asia, China's latest PMI reading provided evidence that tightening measures are working towards achieving a soft landing and inflation has eased somewhat, but pressures still persist.

…but toward less supportive conditions, especially in Europe

However, it is possible that the strong rebound in data is behind us, and that the upside risks to the economic outlook have decreased due to the significant uncertainty stemming from geopolitical risks. The ECB seems to be ready to pre-emptively hike rates, while the Fed did not show concern about the impact of higher energy prices on core inflation and did not signal further changes in the wording of its monetary policy. Higher oil prices have increased uncertainty regarding inflation expectations. However, there is no evidence that a pass-through from oil prices to core inflation is materialising. The spread between input and output prices continues to widen, suggesting that firms are retaining higher production costs in margins. Looking ahead, economic policy will become less supportive for the Eurozone, as a result of the combination of fiscal consolidation, the spike in oil prices, less supportive monetary policy (although ECB monetary policy will remain loose), and euro strength. Moreover the change in ECB wording has pushed up Europe 2Y and 10Y bond yields, which is unhelpful for peripheral solvency problems, especially when there are some concerns about the agreement to reinforce EFSF mechanisms (see highlight).

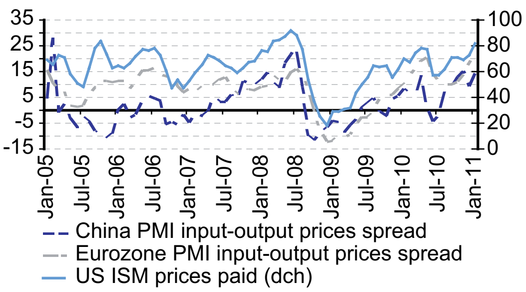
Next week. The EU meeting on competitiveness on March 11th will be in the spotlight. In the US, consumer confidence and retail sales. In Asia, a batch of data from China: inflation, trade data, FDI and loans.

Chart 1
Employment in Manufacturing Strengthens



Source: BBVA Research

Chart 2
Firms Retain Higher Cost in Margins



Source: BBVA Research

Highlights

Special EU Council summit on competitiveness
We only expect a vague agreement.

ECB's pre-emptive approach vs. Fed's wait-and-see stance
Despite this different approach the ECB will not raise rates too quickly with the Fed still on hold.

What is the effect of oil prices on growth?
A temporary increase would be easily accommodated in the US and EMU.

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Markets

Equity: Change in Outlook for ECB rates ratchets up pressure on European bourses

We had already stated that the critical short-term factor for global stock markets was the geopolitical risk stemming from the situation in northern Africa and the Middle East; indeed, the clearly positive correlation between the S&P-500 and the IRR for U.S. 10-year bonds made that relationship clear. We had also noted that for Europe there was a second critical factor: stronger inflationary pressure that was translating into worsening interest-rate expectations. And, in the short term, this favoured a better relative performance of US equities as compared with European equities, and of European "central" bourses as compared with those on the periphery. The reaction of European equities following the Trichet declarations (intraday EuroStoxx-50 -1%, Ibex-35 -2% and the European Banking Sector -3%) confirm this. Hence, although in recent weeks we had seen that the market consensus expected somewhat flat profits for 2011-2012 on the S&P-500 and the EuroStoxx by (but not the Ibex-35, which continues to trend downward), we must not rule out that this scenario may persist or even worsen somewhat in the short term in Europe.Equities continue to be driven by the strength of Wall St: as long as the S&P-500 remains above the support at 1,290-1,300, correcting sidewise (in time, not in price), we believe that the risk of drops in Europe (Spain included) will be limited.

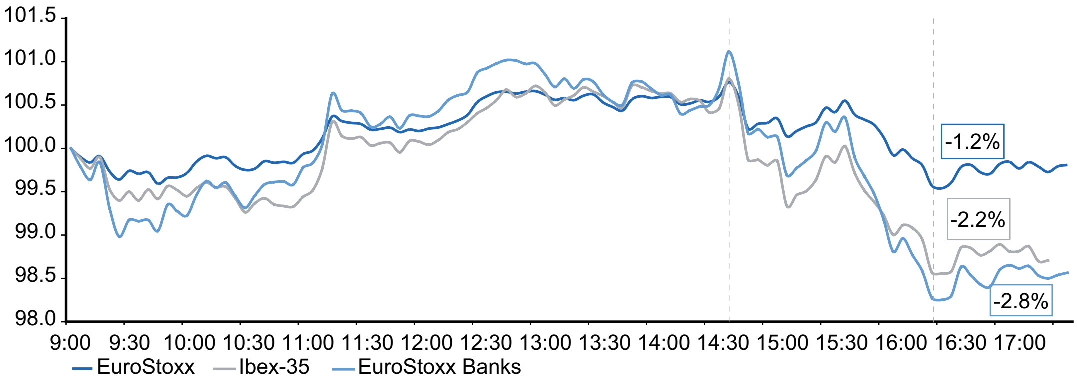
Credit: no negative impact from rates on credit markets

Synthetic indexes have tightened across the board so far this week: the iTraxx Main has tightened 4bps to 99bps while the iTraxx SovX WE tightened 11bps to 175bps. In financial indexes, the iTraxx Senior tightened 18bps to 149bps, while the iTraxx Sub Fin did so by 29bps to 257bps. The fact that financials have been less affected by rises in crude oil prices has allowed them to outperform. We expect the credit market to remain strong, with financials outperforming corporates, since we think the market has already priced in the cyclical recovery of the last two years which may now be threatened by the rise in interest rates. Nevertheless, we do not expect any significant re-leveraging in Industrials despite the current high levels of liquidity: with Capex still contained, no clear threat of transformational M&A and an increase in dividend pay-outs being the most tangible risk in the short term. There is no danger to the current credit metrics.

Forex: Euro Spikes on Trichet's Comments

We continue to see the EURUSD trading lower and remain relatively comfortable with our 1.3650 March forecast for now. The main risk to our forecast appears to be rate hikes sooner rather than later, although much of this is already in the price. The market is now more than 60% priced for a 25bp hike at the 4/7/11 ECB meeting with a (virtual) 100% probability of 25bp on 5/5/11 if no move is made in April. That said, our economics team now believes in the likelihood of two 25bp hikes in the next few months, with an April hike as almost certain. But the large overhang of short USDs, coupled with the fact that the market is probably extremely long of the EURUSD trade already, suggests any move from here is likely to be extremely choppy and not a one-way directional play.

Chart 3
Reaction to the ECB Speech



Source: Bloomberg

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Highlights

Special EU Council summit on competitiveness

On March 11 (next Friday) a special EU Council summit will take place to agree on a competitiveness pact requested by Germany. The idea is to implement reforms in individual countries that help to improve competitiveness of member countries and achieve convergence. Recent leaks suggest that after the bad reception of the original proposal by France and Germany, which small countries considered as an imposition, the agreements is going to be watered down. Germany wanted countries to implement a fiscal rule in national constitutions, eliminate wage indexation clauses to inflation, harmonize tax bases and fix retirement ages in pension systems. Probably the final agreement will touch all these elements, but more with recommendations or vague requirements rather than strict rules. This should not be a problem in principle since, in our view, these reforms miss the point, as the key to solving current market strains in the EU periphery lie elsewhere –more in the current solvency and liquidity problems of sovereigns through European rescue funds (EFSF and, as from 2013, the ESM) and in the mechanisms for dealing with crisis resolution, including eventual bail-ins of the private sector. In this respect, the summit of March 24-25 will be key, but the perspectives look bleaker now than a month ago: after soothing declarations of German leaders in January, several facts point to increasing inflexibility of Germany, including the bad results of the German government coalition in Hamburg and in polls for the end of March elections, the resignation this week of a popular member of the government, the loss of Axel Weber as a candidate to replace Trichet at the ECB and the likely soft agreement in the March 11 summit. Increasingly, Germany and smaller Northern countries seem reluctant to make the EFSF more flexible (allowing it to buy bonds in secondary markets) or even to raise its current ceiling at least to its nominal value. Although markets have been relatively calm after the improvement in January , strains could reignite again after March if the EU Council fails to deliver. This could affect Portugal in particular, which despite being broadly on track in fiscal consolidation has been of the brink of requesting the EFSF for funds as doubts on its growth potential and foreign balance negatively weigh negatively on markets. But the stakes go much beyond Portugal, as a once and for all solution for crisis management is needed for Europe as a whole.

ECB's pre-emptive approach to second-round risks vs. Fed's wait-and-see stance

In an unanticipated degree of hardening in its hawkish tone, the ECB went as far as stating that "strong vigilance" is warranted to avoid second-round effects. The change in the wording makes it clear that the ECB is now ready to pre-emptively hike rates starting in April ie, the ECB hawkish approach is to pre-empt rather than react to second-round effects. And this is the key difference with the approach taken by the Fed, which clearly prefers to wait and act only if risks materialise. In its Semiannual Monetary Policy Report to the Congress, Bernanke did not change the forward-looking language on interest rates –"exceptionally low… for an extended period"– and noted the impact on inflation of commodity price increases will be "at most, temporary and relatively modest". Despite this different approach to second-round risks, the ECB will not raise rates too quickly with the Fed still on hold. We now expect from the ECB a pre-emptive cumulative increase of 50bp in the next few months (most likely +25bp in April and a further +25 bp hike in June or July) before a wait-and-see period re-emerges (pause during at least the remainder of 2011). Further increases would require a de-anchoring of inflation expectations or second-round effects which we don't expect. That is, the ECB is not embarking in a series of rate increases towards policy normalisation (ie, neutrality).

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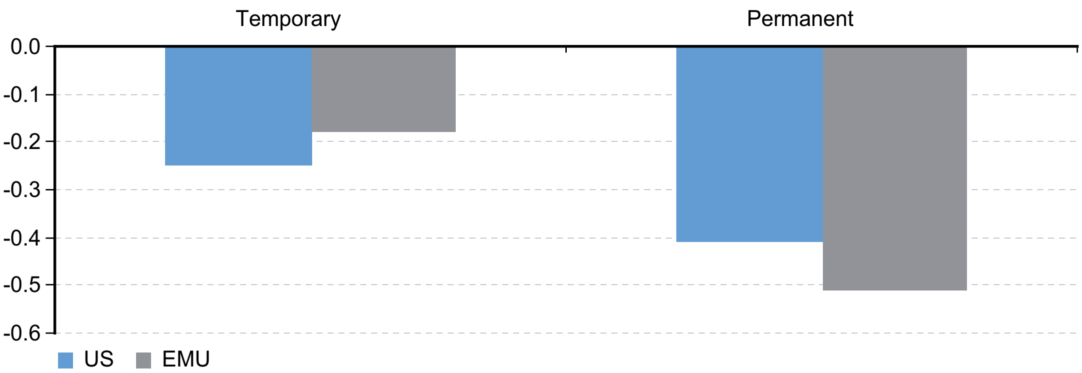
What is the effect of oil prices on growth?

Another week of turmoil in the MENA region, which continues to be reflected in sustained high levels of oil prices. In our opinion –and most market participants'– at present the current shock in oil prices has a high probability of being transitory, as importer's stocks and Saudi Arabia's spare capacity can accommodate the current supply disruption in Libya. Nonetheless, there is a non-negligible chance that the unrest spreads to other oil-producing regions, some of which will be impossible to cover with existing spare capacity, making the rise in oil prices bigger and more permanent.

What would be the growth impact of such scenarios in the US and EMU? As illustration, we present two possible scenarios. Our simulations suggest that a temporary 30% increase in Brent oil prices during 2011Q1 (to 125 USD, reverting to 95 the next quarter) would be easily accommodated in the US and EMU, shaving just 0,2 pp of GDP growth in 2011. However, it would elicit a preventive response by the ECB (but not the Fed) of around 50bp, in line with our assessment above. However, should the 30% oil shock be permanent (keeping prices around 120-125 USD) growth fallouts would be around half a percent in 2011 in both regions, through different channels with different weights in each of them: (i) a direct hit on unit costs and potential output and (ii) the response of monetary policy to possible second-round effects. The direct effect of oil prices on economic activity would be higher in the US on account of its higher energy intensity and smaller hydrocarbon tax wedges (which dampen less the pass-through of oil prices into refined products). On the other hand, given its more hawkish approach to second-round risks to inflation, we factor in this simulation a (traditionally) more aggressive response of the ECB than the Fed to such a shock, which accounts for most of the impact of oil prices on growth in EMU.

Bottom line: Our previous growth forecast for the US and EMU had incorporated risks tilted to the upside. In the case of a temporary oil price shock as described above, those risks would be now basically balanced. However, a sizable and more permanent oil shock with a monetary policy response would seriously risk the ongoing recovery in the US and Europe.

Chart 4
Effect on 2011 GDP Growth of a 30% Increase in Oil Prices



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Calendar: Indicators

Eurozone: Germany: Industrial production output (January, March 9th)

Forecast: 1.7% m/m	**Consensus:** 1.8% m/m	**Previous:** -1.5% m/m

Comment: German industrial output is expected to rebound in January, after the significant drop observed by end-2010 driven by construction output, especially affected by a harsh winter. Soft data for manufacturing and construction for the beginning of the year also suggest that the fall in industrial activity should have been short-lived, as construction sentiment improved again in January, while manufacturing confidence remained relatively stable. Despite of January's rebound, industrial recovery is expected to slow in coming months, after the strong growth rates observed over last year. **Market Impact:** Despite of the volatility of this series along with its frequent revisions, a very negative surprise in still limited hard data for the current quarter could increase concerns about regained momentum at the beginning of the year.

Eurozone: Germany: Trade balance (January, March 10th)

Forecast: €12.8bn	**Consensus:** 13bn.	**Previous:** €14.2bn

Comment: We expect German trade balance (seasonally adjusted) to narrow again in January, mainly driven by a rebound in imports after they significantly fell in December and supported by stronger domestic demand. In contrast, exports are projected to grow more moderately, as at the end of 2010, after having reached pre-crisis levels. But foreign order books have remained robust at the beginning of the year, showing further evidence that overall net exports will continue to be a key driver of growth in coming months. **Market impact:** Due to its volatility, trade data usually have limited impact on markets.

US: Consumer Credit (January, March 7th)

Forecast: $4.95bn	**Consensus:** $3.30bn	**Previous:** $6.10bn

Comment: We expect total outstanding consumer credit to increase MoM by $4.95bn in January to $2415.4bn seasonally-adjusted, which represents a -1.31% YoY decline. One issue with this month's data is the divestment of $25bn in consumer credit from banks to nonbanks in December. We believe that this shift within the total outstanding may affect the seasonality adjustments made within individual categories, so the risk of substantial data revisions is high. Regardless of these data revisions, total consumer credit is growing gingerly MoM for the past few months, but we do not anticipate YoY growth until mid-2011. **Market impact:** Strong consumer credit growth would signal better financial conditions and would support consumer spending in 2011. Therefore, markets would react positively to better-than-expected consumer credit report.

US: Retail Sales (February, March 1st)

Forecast: 0.6% m/m	**Consensus:** 0.8% m/m	**Previous:** 0.3% m/m

Comment: Retail sales climbed 0.3% MoM in January and 0.8% MoM on average in the last seven months. With increase in consumer prices and moderate growth in auto sales support upward trend in retail sales. With better economic prospects and strong consumer expectations we expect retail sales continue increasing in February. Moreover, possible improvements in labor market conditions would also support retail sales in 2011. **Market impact:** Strong real retail sales would be a sign for strong personal consumption and support strong economic recovery in 1Q11 and therefore could support positive trend in stock markets.

China: CPI (February, March 15th)

Forecast: 4.8% y/y	**Consensus:** 4.8% y/y	**Previous:** 4.9% y/y

Comment: February inflation will be released next week with a batch of other important indicators including the producer price index (PPI), new loans, M2 growth, trade, industrial production, retail sales, and investment. Headline inflation is expected to ease slightly as the recent monetary tightening measures take effect. However, the recent run-up of oil prices and tight labor market conditions will keep inflationary pressures high. **Market impact:** A higher-than-expected reading could unnerve markets through expectations of further tightening and risks of a hard landing.

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				Close	Weekly change	Monthly change	Annual change
Interest Rates	(changes in bps)	US	3-month Libor rate	0.31	0	0	6
			2-yr yield	0.78	6	12	-11
			10-yr yield	3.54	13	7	-14
		EMU	3-month Euribor rate	1.16	7	8	51
			2-yr yield	1.76	22	27	76
			10-yr yield	3.32	16	6	16
Exchange Rates	(changes in %)	Europe	Dollar-Euro	1.397	1.5	1.3	2.7
			Pound-Euro	0.86	0.5	0.8	-4.6
			Swiss Franc-Euro	1.30	1.7	0.0	-11.2
		America	Argentina (peso-dollar)	4.03	0.0	0.4	4.3
			Brazil (real-dollar)	1.65	-0.7	-1.1	-7.3
			Colombia (peso-dollar)	1907	0.0	2.6	-1.0
			Chile (peso-dollar)	473	-0.3	-1.6	-7.0
			Mexico (peso-dollar)	11.99	-1.0	-0.3	-5.3
			Peru (Nuevo sol-dollar)	2.77	-0.2	0.2	-2.4
		Asia	Japan (Yen-Dollar)	82.57	1.0	1.1	-8.7
			Korea (KRW-Dollar)	1114.95	-0.8	1.0	-1.7
			Australia (AUD-Dollar)	1.013	-0.2	0.5	11.6
Comm.	(chg %)		Brent oil ($/b)	115.6	3.0	12.9	44.6
			Gold ($/ounce)	1419.0	0.6	6.3	25.1
			Base metals	622.2	0.9	1.5	25.1
Stock Markets	(changes in %)	Euro	Ibex 35	10614	-1.9	-3.6	-3.7
			EuroStoxx 50	2997	0.4	-0.5	4.1
		America	USA (S&P 500)	1331	0.8	2.1	16.9
			Argentina (Merval)	3475	1.2	-4.6	51.2
			Brazil (Bovespa)	68146	1.9	2.2	-1.0
			Colombia (IGBC)	15335	4.0	2.6	29.8
			Chile (IGPA)	21492	2.5	-2.7	21.9
			Mexico (CPI)	37133	0.7	-2.1	14.5
			Peru (General Lima)	22623	-0.6	-3.4	56.8
			Venezuela (IBC)	67692	0.1	1.5	18.9
		Asia	Nikkei225	10694	1.6	2.3	3.1
			HSI	23409	1.7	-2.1	12.6
Credit	(changes in bps)	Ind.	Itraxx Main	99	0	3	21
			Itraxx Xover	384	-12	-19	-42
		Sovereign risk	CDS Germany	47	-7	-6	14
			CDS Portugal	469	1	80	352
			CDS Spain	239	-26	17	137
			CDS USA	44	-2	-3	---
			CDS Emerging	215	-11	3	-28
			CDS Argentina	614	-35	19	-420
			CDS Brazil	114	-4	-1	-8
			CDS Colombia	117	-3	0	-30
			CDS Chile	74	-5	-3	-3
			CDS Mexico	111	-6	-6	-5
			CDS Peru	109	-5	0	-15

Source: Bloomberg and Datastream

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