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Weekly Watch

Global

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Economic Analysis

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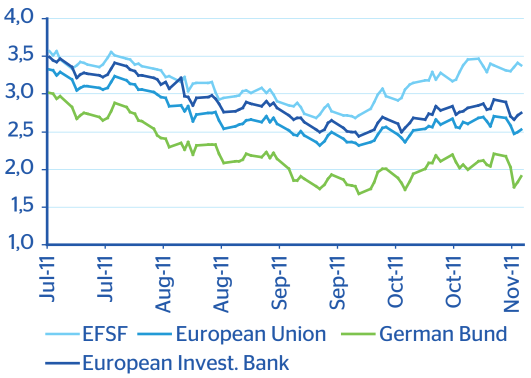
Support from Central banks but lack of concrete deal at G-20

- **Initial euphoria provided by European Packaged has faded**
  There has been a pullback in risk-on mood in financial markets as the initial euphoria, provided by the European package, has faded. Moreover, the absence of any commitment to invest in the European SPV from either Japanese or Chinese governments brought questions about the ability of this product to attract investors. Furthermore, the IMF's statement after the G-20 meeting did not include any reference supporting the European SPV. Despite the Greek Prime Ministry has backed away from his proposed referendum on staying in the euro, peripheral countries' ability in implementing measures imposed by contingent programs is another source of concerns. Portugal will also ask for "greater flexibility" to the Troika ahead of its review program, which takes place this November, while Ireland will ask for a relaxation of its credit conditions. Additionally, Italy has allowed the IMF and the EU to monitor the progress of its structural reforms. Meanwhile, G-20 did not provided any concrete agreements or progress on the European debt crisis. Chinese position on exchange rate flexibility remains unchange. Next week, the Eurogroup and Econfin meetings will keep investors' attention as they would provide more clued on the EFSF leverage..

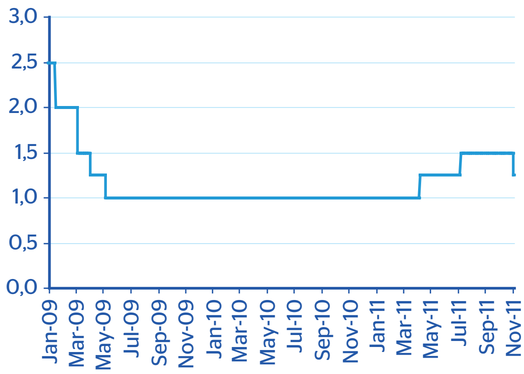
- **The ECB cut interest rate and joined the FED in downgrading the economic outlook**
  The ECB decided unanimously to cut the main policy rate by 0.25%, taking it to 1.25%, in Draghi's first meeting. The European monetary authority considers that the gloomy activity outlook dominates over inflation. We expect another 25 bps cut if the ECB would maintain the pre-emptive approach. Meanwhile, the Federal Reserve left monetary policy on hold on Wednesday and downgraded their economic outlook, continuing to flag downside risks to growth. We believe there is a high probability that a new round of MBS purchases will occur in January. Further more, Asia is seeing policy shifts of its own. Indeed, the Reserve Bank of Australia cut rates this week, ahead of the ECB's move. In recent weeks Singapore, Indonesia, and Japan have also eased monetary policies. The decisions to ease come at a time of rising global uncertainties and downside risks to the economic growth outlook, although aggressive interest rate cuts are not expected.

Chart 1
10Y Yield Trend



Source: Bloomberg and BBVA Research

Chart 2
ECB official rate (%)



Source: ECB and BBVA Research

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The ECB: Edging back towards 1%

The Governing Council decided unanimously to cut the main policy rate by 0.25% to 1.25%, in an unanticipated move. We expect another 25 bps cut if the ECB would maintain the pre-emptive approach. This surprising move comes at the first meeting of Mario Draghi as ECB President. The rate cut has been justified on the materialization of downside risks to economic activity, along with sharp drops in confidence early in October. The Governing Council declared that "some of these risks have been materialising, which makes a significant downward revision to forecasts and projections for average real GDP growth in 2012 very likely ". Moreover when Mr. Draghi was asked about activity risks he replied that "what we observe is that slow growth was heading towards a mild recession by year end". Arguments for the (bold) action are convincing, but to some extent surprising after the recent approach of the Governing council. It is understandable under a pre-emptive (a pragmatic) view, considering the balance of risks that is facing the Eurozone. If this, more realistic approach is maintained, another rate cut can be expected as soon as December.

The statement also emphasizes that "the ongoing tensions in financial markets are likely to dampen the pace of economic growth in the euro area in the second half of this year and beyond". The wording "and beyond" shows that the eventual impact on euro zone growth of the worsening debt crisis would be long-lasting and that price, cost and wage (inflationary) pressures should also moderate. In this context, the weight of the inflation argument (currently at 3%) versus the expected sharp decline in activity seems to have diminished. We agree with this view, as we continue to see inflation to moderate by the end of the year, driven by favourable base effects in energy prices along with the weakness of domestic demand, and reverting below the ECB target by the end of Q1 2012.

Much part of the Q&A was dominated by the Securities Markets Program (SMP). In this respect, Mr. Draghi did not change Mr Trichet's line. He stressed that SMP is temporary, limited in amount, and justified on basis of restoring monetary transmission channels. He also emphasized that governments have to focus on domestic reforms, stabilizing their public finances and embarking on measures to stimulate growth, in order to reduce tensions in debt markets. He also pointed out that the ECB as lender of last resort "is not really in the remit of the ECB". Having said that, we expect the ECB to maintain bond purchases as long as needed.

The FOMC's Statement: Discussion gravitating towards more stimulus

The Federal Reserve left monetary policy on hold on Wednesday and downgraded their economic outlook and, continuing to flag downside risks to growth The Fed mustered a 9-1 vote for a steady course. The three officials who had voted against an easing in September supported the statement. The lack of new insight from the statement reflects the strong internal discussion occurring within the Fed regarding the need for additional stimulus. We believe that a strong probability of additional large-scale asset purchases of MBS exists, but the timing of this is not certain given potential dislocations arising from European negotiations and the US fiscal commission. We regard the first step of the FOMC towards more stimulus will involve a new communication mechanism in December. Our impression is that Bernanke appears to be more amenable to tying action to specific conditions rather than publishing the Fed's forecasts. This will provide the FOMC an incremental step before entering into another large scale asset program that will require more solid support of FOMC members. The December meeting has the potential for more drastic action only if financial conditions worsen considerably. Additionally, January's meeting will involve a change in committee membership and new members will lean more towards Bernanke's views. Therefore, we believe there is a high, but not certain, probability that a new round of MBS purchases will occur in January. Given the "attenuated" transmission mechanism and continuing high unemployment, the Fed will attempt again to push residential investment by engaging in large-scale asset purchases

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The ECB and the FED downgraded economic outlook.

The FOMC's statement suggested that while growth strengthened in the third quarter of the year, overall economic conditions remain insufficiently strong to appreciably reduce the unemployment rate. Growth remains limited by household deleveraging, global financial uncertainty, sluggish residential investment and tight credit conditions. The Federal Reserve's new projections suggest a downgraded outlook for the economy. In particular, the FOMC lowered its bound of estimate for 2012-2013 GDP and increased its projection for the 2012-2013 unemployment rate. The FOMC members concretely slashed their bound of estimate for 2012 GDP growth to 3.5-2.3 percent from 4.0-2.2 percent. Additionally they increased their bound of projection for the 2012-2013 unemployment rates to 8.1-8.9 percent form 8.7-7.5 percent. We share the FED's gloomy economic view. Our GDP growth projections are in the low range of their estimates. Nevertheless, uncertainties should increased downside risk.

In Europe, the materialization of some downside risks to economic activity along with sharp drops in confidence early in October were revealed as the main drivers that have triggered the ECB's refi rate cut. We agree that data over the third quarter confirmed both a revival financial turmoil and the lower momentum of global growth, but really there were not a novelty compared to September, when the ECB staff estimated an annual GDP growth of 1.3% for 2012. However, confidence data, especially PMI, were disappointing in October, pointing to a mild contraction in the last quarter of the year. Although the available data for this quarter is very limited, given the recent developments in the eurozone, the likelihood of a quick and final solution of the European crisis, reflected in our baseline scenario, is decreasing, and thus the risks are in the downside. "Therefore, we can not rule out that the eurozone economy will contract in the last quarter, with a very weak economy in the frst half of 2012 if turbulence in the area is not dispeled. In that case, our growth projection of 1% for 2012 would be clearly at risk. The scenario would be even more negative if the evolution of the crisis in Greece ends up in a disorderly resolution."

China's growth continues to moderate in line with a soft landing

The October PMI reading was released earlier this week, coming in below expectations but still in line with a soft landing in our view. Asian markets generally took the outturn in stride, although the lower-than-expected outturn weighed down on global market sentiment somewhat, especially against renewed uncertainties about Greece and ongoing concerns of a hard landing in China. In particular, the PMI fell to 50.4% in October after two consecutive months of increases (from 50.7% in July to 51.2% in September) and was well below expectations (consensus: 51.8%; BBVA: 51.7%). Although the PMI outturn is the lowest reading since March 2009, it was still within the 50+ expansion zone and reflects a gradual decline toward a soft landing. Moreover, the private-sector (HSBC) PMI, also released on the same day, increased to 51.0% from 49.9% in september, rising above the +50 expansion zone for the first time since July 2010. The weaker official PMI outturn was mainly due to lower new orders (with a weight of 30%), including for exports, which may reflect weakening external demand, consistent with the lower export growth outturn seen in the September data (17.1% y/y). Encouragingly, the subcomponent of production (with a weight of 25%) remained buoyant, declining only marginally, to 52.3% in October from 52.7% in the previous month. Taken together, we believe the trend is in line with our soft-landing scenario, in which we expect a moderation in Q4 GDP growth to 8.4% y/y from 9.1 y/y in Q3 (resulting in a projected annual growth outturn of 9.1% for 2011). On the policy front, the softer PMI reading increases the likelihood of some selective monetary policy easing, which in the coming months could include further measures to expand credit to SMEs and possible cuts in required reserve ratios for smaller banks. Interest rate cuts are unlikely at this juncture given the authorities' ongoing concern about inflation. In the coming week (November 9-15), a stream of important real activity indicators will be released, including inflation, trade, industrial production, investment, sales, money supply, and foreign reserves. At this point, we expect inflation to fall in October, to around 5.3% from 6.1% in September, due to base effects and easing prices on sequential basis, with production and retail sales remaining robust. These will be watched closely for further signs of the resilience of the economy in the face of weakening external demand.

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Forex: Sharp corrections in EUR following the Greek PM's announcement

The increase in risk appetite seen on the FX market following the EU authorities' decision last week proved to be short-lived. The initial sharp rally in risk-sensitive currencies was slowed by caution among investors in response to the event risk of the coming week. The FOMC, ECB and G20 meetings were the focus of the market's attention, reducing purchases of risk assets. However, it was an unforeseen event which triggered increased risk aversion and a rise in volatility. The Greek PM, Papandreou, announced on Monday the intention to hold a referendum for the Greek people on the measures approved at the meeting of European leaders on 27 October. This was a surprise for the market and for European leaders alike, penalizing EUR and high-beta currencies. In the end, the referendum will not take place. The array of macro data published on both sides of the Atlantic, the Fed's cuts to growth forecasts, and the ECB's rate cut were all pushed to the background by this issue. It seems clear that until the European situation is resolved, volatility will continue and events that usually drive the market will remain in the background.

Greek tragedy increases volatility on credit markets

Credit markets continue to be subject to a strong volatility. In the last few trading sessions they gave up last week's gains driven by the EU Summit and announcement of bank recapitalisation. Intra-day swings are common with the market reacting to every piece of news regarding Greece (referendum proposal which was then denied, Papandreou resignation, transitional government, etc). In terms of CDS, the synthetic indices widened by double-digits across the board. The iTraxx Main has widened 17bp so far this week to 168bp. The iTraxx Financials Senior and Subordinated have widened 30bp and 58bp so far this week to 241bp and 454bp respectively.

A major event this week was the release by the ECB of further details regarding the re-established Covered Bond Purchase Programme (CBPP2), first announced on 6 October 2011. The announcement confirmed that purchases under the programme will amount to EUR40bn and will be conducted in the primary and secondary markets between November 2011 and October 2012.

At this point it is difficult to assess whether the ECB Covered Bond Purchase Programme will be successful in reviving the primary issuance market, which is key to easing banking sector funding concerns. The success of this program will also depend on the resolution of the Greek crisis and more details on the leverage of the EFSF aimed at avoiding contagion risk to other peripheral countries. However, the main message, regardless of what happens in the market, is that covered bonds remain the asset class with the highest level of support from European authorities.

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Calendar: Indicators

Eurozone: Retail sales (September, November 7th)

Forecast: -0.3% m/m	Consensus: 0.0% m/m	Previous: 0.1% m/m

Comment: We expect retail sales to have declined slightly in September, after increasing in previous months. Still, these figures reveal that the average for Q3 of retail sales have increased timidly in that quarter, after falling in the first half of the year. Overall, hard data point to the fall in private consumption observed in Q2 should turn to positive numbers in Q3. In contrast, consumers' confidence continues to decline due to increasing concerns about the European crisis and a gloomier economic outlook for coming quarters. This could be weighting negatively on households' spending. **Market impact:** A sharp fall in retail sales could be read as further evidence that the recovery is loosing momentum, increasing fears of a mild activity contraction in the last quarter of the year.

Germany: Industrial production (September, November 7th)

Forecast: -0.5% m/m	Consensus: -0.9% m/m	Previous: -1.0% m/m

Comment: Industrial production is expected to have declined again in September, after falling significantly in August. Nevertheless, these falls should not offset the strong rebound printed in July. Despite that these figures show further evidence that industrial recovery is cooling, the average output in Q3 suggests that GDP is likely to have rebounded in that quarter, after remaining virtually stagnated in Q2. In contrast, soft data for Q3 along with the decline in foreign orders painted a less optimistic picture for the quarter. **Market Impact:** Disappointing figures on industrial production should increase market's fears about the sustainability of the recovery in the last quarter of the year.

US: Wholesale Inventories (September, November 9th)

Forecast: 0.5%	Consensus: 0.6%	Previous: 0.4%

Comment: Historically-high inventories have been a concern among businesses but finally appear to be decelerating. Sluggish demand conditions have contributed to slower growth in wholesale inventories during the summer months compared to earlier in the year. Data from the past few months suggest that wholesalers are beginning to deplete old inventories while consumer demand rebounds. However, regional Federal Reserve surveys have indicated relatively strong inventories for the month, with durable goods stronger than nondurables. While a decline in supply levels is unlikely, we do expect a slowing in inventory accumulation. **Market Impact:** Wholesale inventory reports tend to have little impact on the market, particularly because most troubles usually begin at the retail level. However, a jump back up over August's growth rate could imply continued slowdowns in economic activity.

US: International Trade Balance (September, November 10th)

Forecast: -\$45.0B	Consensus: -\$46.0B	Previous: -\$45.6B

Comment: The trade balance is expected to remain relatively unchanged in September due to continued weakness in global markets. Exports are expected to decline given the slowdowns in demand stemming from the European sovereign debt crisis, but levels remain strong compared to historical trends. Imports, on the other hand, declined in August and are beginning to trend downward on a YoY basis. Businesses remain pessimistic about economic prospects and are likely holding back on importing consumer goods and capital equipment. Thus, slowing in both exports and imports should lead to no significant changes in the trade gap. **Market Impact:** This report will provide markets with a last look at the trade balance for Q3, which can have significant implications for revisions to GDP growth for the quarter. After a more positive Q3 GDP report last week, the lagged report should cause little anxiety in the market unless it suggests a downward revision to the advance GDP estimate.

China: CPI Inflation (October, November 9th)

Forecast: 5.4% yoy	Consensus: 5.5% yoy	Previous: 6.1% yoy

Comment: China's next monthly inflation release will be watched for signs of a further decline, which could bolster expectations of policy easing following this week's release of a lower-than-expected PMI outturn. Until now, high inflation has been a constraint to possible monetary policy easing. Headline inflation has been declining since hitting a peak of 6.5% in July, but remains uncomfortably high at above 6%. We expect a significant drop in year-on-year inflation in October due to food price declines and base effects. **Market impact:** A higher-than-expected outturn would have a negative impact on sentiment by reducing the perceived likelihood of monetary policy easing to support growth if needed in the midst of a weakening global outlook.

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			Close	Weekly change	Monthly change	Annual change
Interest Rates (changes in bps)	US	3-month Libor rate	0.44	1	5	15
		2-yr yield	0.22	-7	-3	-14
		10-yr yield	2.03	-29	14	-50
	EMU	3-month Euribor rate	1.49	-10	-7	44
		2-yr yield	0.39	-21	-10	-52
		10-yr yield	1.81	-37	-3	-61
Exchange Rates (changes in %)	Europe	Dollar-Euro	1.373	-3.0	3.2	-2.4
		Pound-Euro	0.86	-2.2	-0.5	-1.0
		Swiss Franc-Euro	1.22	0.0	-0.7	-9.5
	America	Argentina (peso-dollar)	4.25	0.4	1.1	7.6
		Brazil (real-dollar)	1.76	4.1	-4.2	4.7
		Colombia (peso-dollar)	1917	2.9	-2.8	5.3
		Chile (peso-dollar)	495	0.9	-6.8	3.7
		Mexico (peso-dollar)	13.52	3.2	-1.1	10.8
		Peru (Nuevo sol-dollar)	2.71	0.2	-2.1	-3.0
	Asia	Japan (Yen-Dollar)	78.19	3.2	1.7	-3.9
		Korea (KRW-Dollar)	1112.35	0.8	-6.3	0.5
		Australia (AUD-Dollar)	1.033	-3.6	7.5	1.7
Comm. (chg %)		Brent oil ($/b)	110.9	0.9	7.9	25.8
		Gold ($/ounce)	1753.3	0.5	6.8	25.8
		Base metals	536.1	-0.7	0.2	-4.0
Stock Markets (changes in %)	Euro	Ibex 35	8584	-6.9	1.3	-17.7
		EuroStoxx 50	2300	-6.6	5.5	-20.0
	America	USA (S&P 500)	1241	-3.4	8.5	1.2
		Argentina (Merval)	2760	-8.5	19.5	-17.7
		Brazil (Bovespa)	58006	-2.5	13.7	-20.1
		Colombia (IGBC)	13125	-3.0	3.4	-19.4
		Chile (IGPA)	20416	-1.4	13.3	-11.2
		Mexico (CPI)	36552	-0.4	10.8	0.6
		Peru (General Lima)	19531	-2.6	11.3	-4.3
		Venezuela (IBC)	108204	1.8	8.5	60.0
	Asia	Nikkei225	8801	-2.8	5.0	-8.6
		HSI	19843	-0.9	22.1	-20.2
Credit (changes in bps)	Ind.	Itraxx Main	168	18	-30	71
		Itraxx Xover	689	70	-154	259
	Sovereign risk	CDS Germany	87	11	-21	51
		CDS Portugal	1005	37	-135	561
		CDS Spain	371	57	-5	123
		CDS USA	47	9	-4	---
		CDS Emerging	275	13	-88	85
		CDS Argentina	866	21	-279	266
		CDS Brazil	140	6	-57	47
		CDS Colombia	139	3	-61	44
		CDS Chile	110	7	-46	44
		CDS Mexico	141	11	-56	42
		CDS Peru	144	8	-57	41

Source: Bloomberg and Datastream

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