BBVA Research

Global

Weekly Watch

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Economic Analysis

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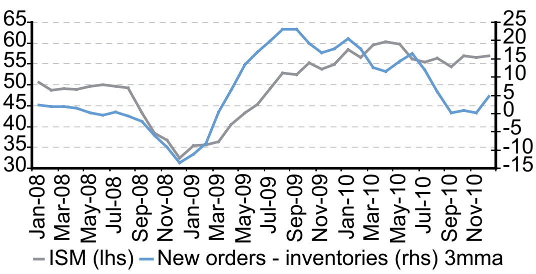
Recovery is on track

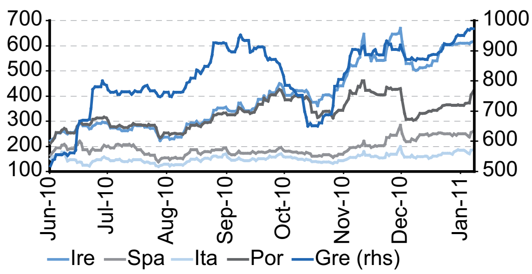
Strong December manufacturing data was released on both sides of the Atlantic this week, further signalling that the economic recovery is gaining momentum. In the US, the ISM index rose to 57 from 56.6, which is the fastest pace in 7 months. Moreover, the details of the report were stronger than the headline, with the gap between new orders and inventories increasing to a 6 month high and thus suggesting that manufacturing activity is likely to accelerate in 1Q11. Additionaly, the payrolls figure released today rose less than expected by 103K in December, while the unemployment rate fell to 9.4%. In Europe, the final manufacturing PMI was revised upwards for the Eurozone to 57.1 from 56.8, fueling the sentiment that growth momentum remained in Q4. Meanwhile, China's PMI came out lower than expected, at 53.9% (consensus: 55.0%), following four consecutive months of stronger-than-expected outturns and five straight months of increases. This should help allay rising concerns of economic overheating. Next week, the ECB and BoE meetings will be held, but we do not anticipate any major changes.

Chart 1
ISM & New Orders Less Inventories



Source: Bloomberg and BBVA Research

Chart 2
Sovereign Spreads: 10yr Bond (bps)



Source: BBVA Research

Markets

In the first few days of trading of 2011 the upward trend in OECD interest rates continued to tail off, as it had been doing at the end of 2010. As a result, 10Y European swap rates have continued to fall (the 10Y swap by 10bps, once again dropping below 3.20%), while US rates, despite reacting to the strength of the latest data (ADP), have not exceeded the highs reached in December (still below 3.50%). There are various factors that must be considered in terms of this trend in rates, as it is taking place: i) despite a phase of greater confidence vis-à-vis the cycle; ii) when inflation indicators are rising due to transitory circumstances; and iii) whilst the central bank monetary policy maintains a particularly lax outlook.

Nonetheless, the sovereign risk remains a cause for concern. Credit spreads have widened this week again losing the ground gained in the first sessions of the year. A disappointing 6-M bill auction in Portugal, an increasing belief in the market (according to recent opinion polls) that Portugal will end up needing a bailout, and the release of an official EU working document regarding the framework for the resolution of the crisis in the financial sector (which would include haircuts to banks' new senior debt as of 2013) have all contributed to the change in this positive trend, showing that concerns over Europe remain in place.

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Economic prospects for 2011

In 2011 the world economy will consolidate the recovery seen in 2010, albeit at a slower pace.

2011 outlook for interest and exchange rates, equity and credit

Upcoming events

Upcoming events in the first quarter of 2011 could have a significant effect on the European sovereign risk situation.

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Highlights

Economic prospects for 2011

The world economy performed better than expected in 2010, with growth close to 4.8%. Furthermore, many expected risks, such as a double dip recession in the US or a sharp slowdown in Asia, have not materialized. In 2011 the world economy will consolidate the recovery, albeit at a slower pace. Emerging economies will continue to have an undeniable role in global growth. They will almost triple developed economies' growth and will strongly contribute to the global growth. On the other hand, developed economies will continue benefiting from non-standard measures and liquidity support. However, the process of deleveraging in the private sector, still pending, and the fiscal consolidation will have a moderating effect so that its growth will be positive but low, particularly in the Eurozone. In any case, 2011 is not exempt from risks arising from an insufficiently robust financial system, low level of job creation, sustainability of public accounts and the risk of overheating in Emerging Markets.

2011 outlook for interest and exchange rates, equity and credit

For interest and exchange rates, the ongoing sovereign and financial risk in the Eurozone (especially during the first half of the year), as well as the still moderate cyclical recovery in OECD economies, will continue to require ultra-lax policies from central banks. This should continue to limit interest rates' capacity to rise all along the curves. The second half of the year should offer slightly more scope for rises in the longer term, although without moving too far away from recent highs (3.60% in the US 10Y, 3.40% in the German 10Y). Furthermore, as long as the risk in peripherals remains, the euro risk premium will continue to be higher vs. the dollar (a potential return to the EURUSD 1.25 zone before June). The euro may subsequently make up some lost ground, but the cross should still remain close to EURUSD1.30.

Western markets may have a positive 2011. In the S&P 500, we estimate 1,350 points (+10% including currency effect at the current price) at 12/31/2011. We see more value in Europe (+19% for the EuroStoxx-50 to 3,400 points), although this could take some time to be priced in.

Lastly, corporate credit valuations are at attractive levels, with wide spreads between entities which have high ratings. These valuations still offer upside potential in 2011. However, despite this positive valuation, we expect to see some outbreaks of high volatility throughout the coming year. These periods of high volatility will make investors question the ability of peripheral countries to reduce their deficit and to face their financing needs in general.

Upcoming events

Upcoming events in the first quarter of 2011 could have a significant effect on the European sovereign risk situation. Spain will approve its pension reform on January 28th. The ECOFIN council meetings will take place on January 18th and February 15th, but we do not expect any concrete resolutions until the European Council on March 24th. Meanwhile, the Governing Council of the ECB will be meeting in Frankfurt on January 13th, February 2nd, and March 2nd; monetary policy changes are unlikely. During February there will be a new European stress test along with Irish legislation on a rescue package that is expected to be passed. In March, the Spanish government is set to approve a reform on wage bargaining. If tensions remain high in the months before the EU Council meeting then some measures could be taken beforehand to ease pressures, but they will not be officially ratified until the EU Council in March.

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Calendar: Indicators

Eurozone: Trade balance (November, January 14th)

Forecast: €6.3bn	**Consensus:** n.d.	**Previous:** €5.2bn

Comment: The trade surplus is likely to have widened slightly in November. Exports are expected to have maintained their momentum as demand from emerging markets remains resilient. However, imports are expected to grow at a higher rate, in line with signs of stronger domestic demand. Looking forward, we expect the exports recovery to weaken in coming months, but remain resilient, helped by the support from the Asian economies, which could partly offset the impact of the U.S. slowdown on the euro. **Market Impact:** Although the trade series are volatile, a very negative surprise could have a market impact by raising concerns about the main driver of the recovery, i.e. the external sector.

Eurozone: Industrial production index (November, January 12th)

Forecast: -0.2% m/m	**Consensus:** 0.5% m/m	**Previous:** 0.6% m/m

Comment: After the moderate increase of the industrial production index in the Eurozone in October and the negative surprise in Germany, we expect a mild decline in November. Industrial activity remains hesitant in its recovery, showing divergences across members, with countries in the periphery showing weaknesses and Germany slowing down compared to the very good performance by mid-year but still robust. **Market Impact:** A negative surprise would be perceived as a sign of contagion from financial turbulence to the real economy.

US: Consumer Price Index, core (December, January 14th)

Forecast: 0.4%, 0.1% m/m	**Consensus:** 0.4%, 0.1% m/m	**Previous:** 0.1%, 0.1% m/m

Comment: Both headline and core consumer price index increased by 0.1% in November on a seasonally adjusted basis. Headline consumer prices rose 1.1% in the last 12 months, a decline from 1.2%. The food and energy price indices rose 0.2% in November. The increase in the energy index is the smallest hike in the last five months. The 12-month increase in the energy index is 3.9%. The gasoline index hiked 7.3% while the household energy index dropped 0.2% in the same period. Housing prices increased by 0.1% in the last 12 months, the first increase since June 2009. The increase in energy prices, including oil, in the last month is likely to boost headline inflation in December. **Market impact:** Although not expected, significant increase in core CPI would calm down discussions on deflationary risks.

US: Industrial Production (December, January 14th)

Forecast: 0.4%	**Consensus:** 0.4%	**Previous:** 0.4%

Comment: In November, industrial production (IP) increased by 0.4%, following a 0.2% decline in the previous month. IP has increased in the last 17 months, except last October. While manufacturing production has increased in the last five months, production in the mining industry continued to decline. Consistent with IP index, the total capacity utilization rate increased to 75.2% in November. While the capacity utilization rate in utilities rose 1.5pp to 78.4%, it declined 0.1pp to 88.7% in the mining industry in October. We expect the IP index and total capacity utilization rate to have continued to increase moderately in December. **Market impact:** Strong industrial production activity in December would imply that the U.S. economy grew faster than 2.7 in 2010.

China: New RMB Loans (December, January 12th)

Forecast: RMB 420 billion	**Consensus:** RMB 360 billion	**Previous:** RMB 564 billion

Comment: New RMB loans for December will be released together with a batch of other important monthly indicators including exports, imports, the trade balance, FDI, foreign exchange reserve, property prices and money growth. Along with the other indicators, new loan growth will be watched closely given the authorities' increasingly aggressive efforts to rein in credit growth to tame inflation and achieve a soft landing for the economy. The authorities' annual target ceiling (RMB 7.5 trillion) for full-year 2010 was essentially reached in November, meaning that the December outturn will likely breach the target (we project overall credit growth of 19.7% y/y for December). **Market impact:** A higher-than-expected reading could increase expectations of further monetary tightening measures.

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				Close	Weekly change	Monthly change	Annual change
Interest Rates	(changes in bps)	US	3-month Libor rate	0.30	0	0	5
			2-yr yield	0.62	2	-1	-36
			10-yr yield	3.39	9	11	-44
		EMU	3-month Euribor rate	1.00	-1	-3	31
			2-yr yield	0.88	2	-12	-36
			10-yr yield	2.90	-6	-11	-48
Exchange Rates	(changes in %)	Europe	Dollar-Euro	1.297	-3.0	-1.9	-9.9
			Pound-Euro	0.84	-2.5	-0.3	-7.1
			Swiss Franc-Euro	1.25	0.4	-4.3	-15.2
		America	Argentina (peso-dollar)	3.97	-0.1	-0.2	4.6
			Brazil (real-dollar)	1.68	1.3	-0.8	-2.8
			Colombia (peso-dollar)	1854	-3.4	-1.5	-5.7
			Chile (peso-dollar)	497	6.2	4.2	0.7
			Mexico (peso-dollar)	12.20	-1.2	-2.1	-3.9
			Peru (Nuevo sol-dollar)	2.80	-0.1	-0.5	-1.6
		Asia	Japan (Yen-Dollar)	83.23	2.5	-1.2	-10.1
			Korea (KRW-Dollar)	1120.70	-0.4	-1.9	-0.4
			Australia (AUD-Dollar)	0.998	-2.5	2.1	8.1
Comm.	(chg %)		Brent oil ($/b)	93.9	-0.9	3.5	15.4
			Gold ($/ounce)	1366.3	-3.8	-1.1	20.0
			Base metals	582.5	-0.2	2.0	16.9
Stock Markets	(changes in %)	Euro	Ibex 35	9597	-2.7	-4.8	-21.1
			EuroStoxx 50	2828	1.3	0.3	-6.3
		America	USA (S&P 500)	1273	1.2	3.6	11.2
			Argentina (Merval)	3616	2.6	5.5	53.7
			Brazil (Bovespa)	70345	1.5	3.2	0.1
			Colombia (IGBC)	15050	-2.9	-2.6	29.2
			Chile (IGPA)	23415	1.9	1.3	36.2
			Mexico (CPI)	38597	0.1	2.6	17.3
			Peru (General Lima)	23290	-0.4	6.3	49.0
			Venezuela (IBC)	65794	0.7	0.5	21.0
		Asia	Nikkei225	10541	3.1	3.0	-2.4
			HSI	23687	2.8	2.6	6.2
Credit	(changes in bps)	Ind.	Itraxx Main	109	4	3	42
			Itraxx Xover	429	-8	-27	35
		Sovereign risk	CDS Germany	56	-2	6	30
			CDS Portugal	507	7	75	415
			CDS Spain	348	-2	43	240
			CDS USA	40	-2	0	---
			CDS Emerging	201	0	-12	-36
			CDS Argentina	564	-38	-72	-411
			CDS Brazil	107	-4	-2	-9
			CDS Colombia	108	-5	-2	-24
			CDS Chile	81	-4	-2	22
			CDS Mexico	110	-3	1	-13
			CDS Peru	108	-5	-6	-8

Source: Bloomberg and Datastream

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