RESEARCH

Weekly Watch
Global

Madrid, 7 October 2011
Economic Analysis

Financial Scenarios
Sonsoles Castillo
s.castillo@bbva.com
+34 91 374 44 32

Cristina Varela Donoso
cvarela@bbva.com
+34 91 537 7825

Javier Amador
javier.amadord@bbva.com
+34 91 374 31 61

María Martínez Álvarez
maria.martinez.alvarez@bbva.com
+34 91 537 66 83

Felipe Insunza
felipe.insunza@bbva.com
+34 91 537 76 80

Central banks boost unconventional measures in an attempt to ease worries

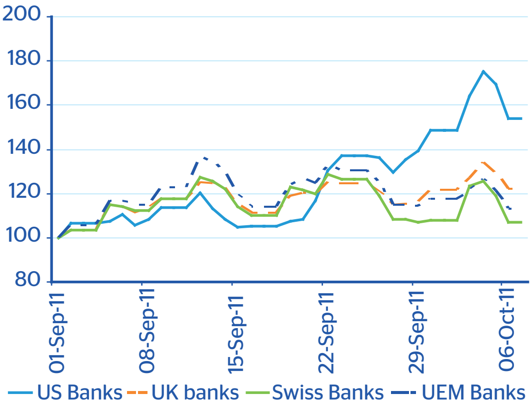
- **Risk aversion continues to ease**
  Risk assets rallied during the end of the week helped by central banks' decisions and expectations of coordinated actions to recapitalize the European banking sector.

- **Eurozone officials might be about to announce a coordinated recapitalization of the European banking sector**
  In a context of a continued marked vicious circle between banks and sovereign bonds, and with financial risk spreading to other economic areas, comments from European officials suggest that coordinated action to recapitalize the European banking sector can be expected soon. Unlike 2009, this time around the effort to strengthen banks' capital position should be shared with European institutions, but this is still just a plan that needs to be defined. In our view this would be a positive step, but in order to restore investors' confidence it should be done with additional measures to resolve sovereign debt problems. This is consistent with our view that Europe will continue to muddle through, taking small steps.

- **The BoE might have been bolder but the ECB also did more than expected**
  Central banks have been bold (much more than governments up until now) in their attempts to dispel concerns. The BoE surprised markets by announcing an increase of its QE (by £75 billion, to £275 billion). The ECB also did more than anticipated. The focus was on helping euro area bank funding. The ECB announced a substantial expansion of LTROs and launched a €40bn programme to buy covered bonds.

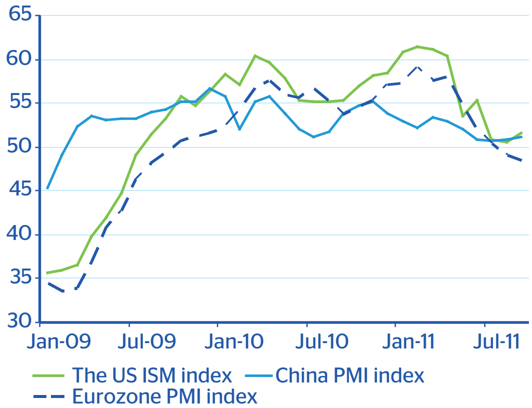
- **Activity data was more supportive in the US and remains resilient in emerging markets. In contrast, European indicators continue to point to deterioration**

Chart 1
Banks 5Y CDS (100=Sept 2011)



Source: Bloomberg

Chart 2
Manufacturing activity



Source: Bloomberg

Economic Analysis

Eurozone officials might be about to announce coordinated recapitalization of the European Banking Sector

In a context of a continued marked vicious circle between banks and sovereign bonds, and with financial risk spreading to other economic areas, comments from European officials suggest that co-ordinated action to recapitalize the European banking sector can be expected soon. Unlike 2009, when individual countries shouldered the recapitalization of the Banking sector, the effort to strengthen banks' capital positions should be shared with European institutions. Otherwise it could backfire if the support ends up affecting sovereign bonds further.

The amendment of the EFSF (still pending approval from the Maltese and Slovakian parliaments next week) allows the European financial mechanism to recapitalize banks. Banks' recapitalization needs are not easy to forecast. The banking sector problem lies in the quality of the assets that banks have in their balance sheets. Therefore, the amount needed to recapitalize banks depends on the stress assumptions: the result could be a wide rage of capital needs. In fact, the EBA may be preparing a stress test to identify banks' capitalization needs. The question here is to what extent the banking system should be recapitalized? Depending on the assumptions, the estimated capital needs could range from €25bn to €300bn. The larger amount would represent more than the 60% of the effective lending capacity of the amended EFSF and would leave the EFSF with a limited capacity to help sovereigns (bear in mind that another third of the EFSF's lending capacity is committed to Ireland, Portugal and Greece). All in all, we think that a co-ordinated effort to recapitalize the European banking sector is possible, and would mark another positive step taken by Europe, but it is not enough to solve the problems. To restore investors' confidence both banking sector recapitalization and sovereign debt issues must be addressed. As an example of how important it is to address sovereign debt problems, Moody's downgraded Italy's rating by three notches to A2 from Aa2 and kept the negative outlook, which is mainly related to "ongoing economic and financial risks in Italy and in the euro area". In particular, Moody's stressed in the statement that "The uncertain market environment and the risk of further deterioration in investor sentiment could constrain the country's access to the public debt markets." In this context, Europe's approach continues to be muddled, only taking baby steps. The French and German summit this weekend and the European leaders' summit on October 18th will be important milestones.

The BoE might have been bolder but the ECB also did more than expected

Central banks have been bold (much more than governments up until now) in their attempts to dispel concerns. The Fed's "Operation Twist" is already up and running and Bernanke said that they are prepared to implement new measures if the economic outlook deteriorates further. The BoE surprised markets by announcing an increase of its QE (by £75 billion, to £275 billion). This additional stimulus came sooner and was of a greater scale than had been expected. The ECB also did more than anticipated. The focus was on helping euro area bank funding. The ECB announced a substantial expansion of LTROs (two LTROs: a 12-month in October and one with a maturity of around 13 months in December will be conducted) which will allow banks to fund their liquidity needs in two year-end periods, and launched a €40bn programme to buy covered bonds from November 2011 through October 2012. Furthermore, the ECB also opened the door a bit more to interest rate cuts (a rate cut was discussed) but it seems clear that they are not likely to act pre-emptively as they have done when facing upside inflation risks (see the last ECB Watch).

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Activity data was more supportive in the US, and remains resilient in emerging markets. In contrast, European indicators continue to point to deterioration

Economic data this week has been supportive, dispelling strong fears of a US deceleration that markets have been pricing in since August. Both manufacturing and non-manufacturing ISM indexes came in higher than expected. Furthermore, labor market data this week was also better than expected with lower jobless claims and healthier job creation, which gives hope for some strengthening going forward. In contrast, in Europe, both the manufacturing PMI figures and the PMI services for September suggested that the downward trend in the euro zone economic activity remains intact.

In most Latin-American countries, monthly inflation in September was higher than in previous months and exceeded the market's expectations, while economic activity and employment remain resilient. However, a change in monetary policy biases is unlikely in a context dominated by uncertainty about the global situation. However, if inflation pressures build up (in a context of weaker currencies) and signs of a slowdown in demand and employment do not become more evident, central banks will have to remain in a wait-and-see mode (see the last Latam Weekly Watch).

In Asia, economic data also suggested that growth remains resilient. China's September PMI outturn was a relief, showing an upturn, and some of the recent trade figures in the region have been reassuring as well. Meanwhile, a number of countries released inflation prints for September, showing an easing of price pressures as expected, providing room for policy manoeuvre in the event of a worsening global environment. Despite the reassuring data, markets are fixated on concerns about whether China can sustain its growth in the midst of a global downturn. In this regard, new data to be released in the coming weeks (October 10-18) will be key, especially September inflation (see Weekly Indicator), trade, industrial production, investment, and retail sales. In addition, the third quarter GDP outturn is scheduled for release on October 18. We continue to believe that growth is slowing in line with a soft landing scenario, although there are now increasing downside risks to our full-year projections of 9.2% and 8.9% for 2011 and 2012 given global uncertainties. On the policy front, we expect the Chinese authorities to maintain the current stance of monetary policy through the end of the year (see the last Asian Weekly Watch).

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Global FX
Chief Strategist
Dustin T. Reid
Dustin.Reid@bbvany.com
+1 212 7281707

Global Interest Rates
Interest Rates Europe and USA
José Miguel Rodríguez Delgado
josemiguel.rodriguez@grupobbva.com
+34 91 374 68 97

Global Credit
Credit Europe
Antonio Vilela
antonio.vilela@grupobbva.com
+34 91 374 56 84

Markets

Interest Rates: the ECB is more focused on liquidity than on rates

The longer ends of the curve may react to ECB´s efforts to temper risk premiums, though movements will be limited. While core long yields may spike here and there (Germany's benchmark yield was up 10bp yesterday) for now we do not think a decided bullish rally is feasible (our medium-term threshold for the bund remains at 2.10%/2.20%). It is worth noting that uncertainty persists on crucial issues, such as recapitalisation of the banking system and payment of the next tranche of Greek bailout funds. This potentially greater scope for core yields to climb, combined with new liquidity and financing measures, should also ease the pressure on core/non-core spreads, which, thanks to optimism and a good auction result in Spain (the maximum targeted amount was placed at a lower yield than at previous sales) narrowed by 18bp yesterday, with the Spanish 10Y yield now under 5%.

Forex: Technical Picture Still Quite Important for EURUSD Outlook

ECB President Trichet's last meeting as President brought a smorgasbord of new initiatives to try and kick start the European economy. Although rates were kept on hold as most, but not all, in the market had anticipated including BBVA, the plethora of additional non-standard measures highlights the ECB's ongoing concerns for the EMU outlook.

Although traditionally the impact of additional liquidity into a country's money market supply typically translates into a depreciating domestic currency (the Bank of England's announcement yesterday morning and GBPUSD's reaction, as an example), given all the issues currently facing the EMU, we believe today's actions should prove mildly supportive to EUR. While it is difficult to be outright bullish EUR given the bearish EURUSD technical picture (please see "EUR Succumbs to Market Chatter; 1.3467 Level Key" – 9 September, 2011, as well as subsequent publications) we do not believe yesterday's ECB actions should translate into a reason for additional EUR-selling in-and-ofthemselves with additional EUR selling likely coming as a result of the ongoing peripheral EMU debt situation and momentum players continuing to focus on the bearish technical picture.

Credit: ECB gives credit markets some space to breath

Markets seem to have been taking a short rest over the past week. Improved sentiment on credit markets has been marked by an expectation of a coordinated political response to rein in the sovereign and financial crisis. This positive sentiment continued following Trichet's announcement that the ECB would purchase covered bonds on the primary and secondary markets worth EUR40bn (vs. EUR60bn in 2009), since this could help to ease the tension that is currently afflicting European entities on the primary market. Despite this news, we believe that in the short term caution should prevail. Not only is the potential outcome of the sovereign crisis still very uncertain, we also expect volatility to remain high on the market in a context of limited trading volumes. Having said this, the iTraxx Main tightened 7bp to 194bp and the iTraxx SovX 2bp to 336bp. In financials the iTraxx Fin Senior and Sub tightened 21bp and 23bp to 258bp and 506bp respectively.

The week has been marked by Moody's downgrade of the Italian sovereign from Aa2 to A2, with a negative outlook. Although the downgrade was more than expected, we think a three-notch cut suggests that the agency is implicitly acknowledging that its previous rating was not correct. Following this move, on Thursday Moody's cut the ratings of Italian banks, and some of the major Italian corporates: Finmeccanica down from A3 to Baa2, Terna from A3 to A2, Eni from Aa3 to A1 and Enel from A2 to A3. The reason it gave for the downgrades was that government support for these companies has weakened (stand-alone rating). In Italian banks, the action is not only a result of the sovereign downgrade, but also changes to the assumed government support. The agency has therefore cut Unicredit's and Intesa's ratings by two notches to A2.

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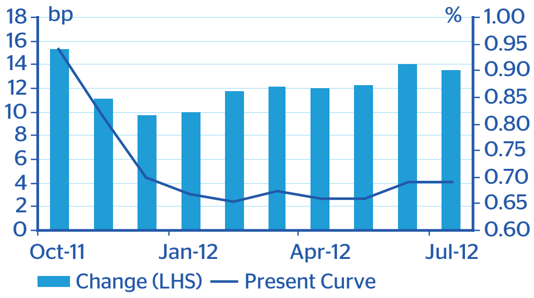
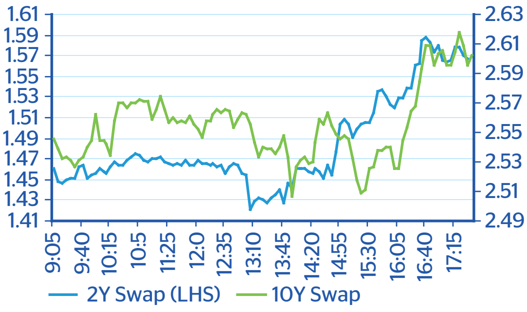
Chart 3
Forward Eonia intraday change* and present level



* During ECB Meeting
Source: Bloomberg and BBVA Research

Chart 4
Swap curve intraday change*



* During ECB Meeting
Source: Bloomberg and BBVA Research

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Europe
Agustín García
agustin.garcia@bbva.com
+34 91 3747938

US
Kim Fraser
kim.fraser@bbvacompass.com
+1 713 881 0655

Asia
Zhigang Li
zhigang.li@bbva.com.hk
+852 2582 3162

Calendar: Indicators

Eurozone: Industrial production (August, October 12th)

Forecast: -0.7% m/m	Consensus: -0.8% m/m	Previous: 0.9% m/m

Comment: Industrial output is expected to have declined in August, offsetting the increase previously observed. According to these expectations, activity could have been nearly flat in July-August, which implies a slowdown in the rapid deterioration trend observed since end-2010. In contrast to this, soft data for the entire Q3 have been more disappointing and point to a contraction in industrial production driven by fading external demand. **Market impact:** A sharp decline in industrial production could increase concerns about a double-deep in the eurozone, as it would confirm the gloomy economic outlook painted by soft data.

Eurozone: Exports (August, October 14th)

Forecast: 0.3% m/m	Consensus: n.a.	Previous: 2.0% m/m

Comment: We expect exports to have increased slightly in August, after the rebound in July. These two consecutive monthly increases would not be enough to offset the sharp decline observed in June and, therefore, the exports levels through July and August are probably 1% below the average of Q2. In addition, orders from abroad coming from confidence surveys do not point to an improvement in the coming months. **Market Impact:** Disappointing figures should adversely affect markets as the key driver of the recovery is vanishing.

US: International Trade (August, October 13th)

Forecast: -\$45.0B	Consensus: -\$46.0B	Previous: -\$44.8B

Comment: Slowdowns in the global economy likely weighed on international transactions in August, and we expect the trade balance to remain relatively unchanged. Both imports and exports are expected to decline as a result of reduced demand for goods and services, both in the US and abroad. A monthly decline in import prices likely deflated the value of imports, while a large jump in export prices may have further discouraged external demand. With increased concerns of an economic slowdown in the developed world, we do not expect substantial changes to the trade gap. **Market Impact:** Markets are well aware of slowdowns in the global economy and have already priced in most of the weak data. However, large shifts in the trade balance could have significant implications for 3Q11 GDP.

US: Retail Sales, Ex. Auto (September, October 14th)

Forecast: 0.3%, 0.1% m/m	Consensus: 0.4%, 0.2% m/m	Previous: 0.0%, 0.1% m/m

Comment: Strong auto sales likely contributed to an increase in retail sales for September despite continued weakness in consumer activity. While domestic and imported vehicle sales were positive, soft demand and price declines likely influenced weakness in gasoline sales. Furthermore, various retail surveys indicate slowing sales for the month as a result of intensified consumer concern over the economy. Although consumer confidence indicators edged up slightly, they continue to suggest uncertainty over a deteriorating economy. Thus, we expect only modest growth in retail sales for September. **Market Impact:** Market expectations for a rebound in consumer activity are low, however a significant jump in retail sales could turn the tables and reduce market anxiety.

China: China CPI for September (October 14th)

Forecast: 6.1% yoy	Consensus: 6.2% yoy	Previous: 6.2% yoy

Comment: Amidst increasing worries about the external environment and implications for growth, domestic inflation remains a concern for China's policy-makers. Headline inflation has soared above 6% y/y in recent months, although it began to fall in August after peaking the previous month at 6.5% y/y. We expect the moderation trend to continue in September due to base effects and easing food prices. **Market impact:** A higher-than-expected reading would be interpreted as limiting authorities' room for monetary policy manoeuvre against headwinds from the external environment, and could undermine market sentiment; a lower-than-expected reading, on the other hand, would strengthen the soft-landing view.

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			Close	Weekly change	Monthly change	Annual change
Interest Rates (changes in bps)	US	3-month Libor rate	0.39	2	5	10
		2-yr yield	0.27	3	7	-7
		10-yr yield	2.08	17	4	-31
	EMU	3-month Euribor rate	1.57	1	3	59
		2-yr yield	0.62	7	13	-17
		10-yr yield	2.00	11	9	-26
Exchange Rates (changes in %)	Europe	Dollar-Euro	1.349	0.3	-4.0	-3.0
		Pound-Euro	0.86	0.5	-2.0	-1.0
		Swiss Franc-Euro	1.23	1.5	2.1	-7.7
	America	Argentina (peso-dollar)	4.21	0.1	0.1	6.3
		Brazil (real-dollar)	1.76	-5.2	6.1	5.5
		Colombia (peso-dollar)	1928	0.2	7.7	8.0
		Chile (peso-dollar)	513	-1.4	10.7	6.4
		Mexico (peso-dollar)	13.28	-3.9	6.4	6.7
		Peru (Nuevo sol-dollar)	2.74	-1.2	0.5	-1.8
	Asia	Japan (Yen-Dollar)	76.74	-0.5	-0.8	-6.3
		Korea (KRW-Dollar)	1176.05	-0.4	9.9	5.5
		Australia (AUD-Dollar)	0.985	1.3	-7.3	0.0
Comm. (chg %)		Brent oil ($/b)	105.7	2.8	-8.7	25.8
		Gold ($/ounce)	1656.4	2.0	-8.9	23.0
		Base metals	537.5	0.3	-6.2	0.7
Stock Markets (changes in %)	Euro	Ibex 35	8789	2.8	7.8	-18.0
		EuroStoxx 50	2271	4.2	5.6	-18.5
	America	USA (S&P 500)	1164	2.9	-2.9	-0.1
		Argentina (Merval)	2365	-4.0	-17.8	-12.4
		Brazil (Bovespa)	52545	0.4	-7.2	-25.8
		Colombia (IGBC)	13080	1.3	-3.4	-14.1
		Chile (IGPA)	18744	-0.3	-7.1	-14.8
		Mexico (CPI)	33470	-0.1	-4.9	-2.9
		Peru (General Lima)	17838	-2.7	-11.4	-5.4
		Venezuela (IBC)	99696	0.1	-0.1	50.4
	Asia	Nikkei225	8606	-1.1	-1.8	-10.3
		HSI	17707	0.7	-11.7	-22.8
Credit (changes in bps)	Ind.	Itraxx Main	189	-13	14	87
		Itraxx Xover	813	-26	95	344
	Sovereign risk	CDS Germany	97	-15	19	61
		CDS Portugal	1117	8	80	718
		CDS Spain	361	-21	-7	143
		CDS USA	51	-1	0	---
		CDS Emerging	348	-26	68	150
		CDS Argentina	1130	46	298	427
		CDS Brazil	188	-14	35	89
		CDS Colombia	190	-9	38	89
		CDS Chile	149	-5	48	84
		CDS Mexico	185	-12	34	82
		CDS Peru	191	-12	34	89

Source: Bloomberg and Datastream

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