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Weekly Watch
Global

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Economic Analysis

Financial Scenarios
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Short-lived relief

Sentiment among investors has slightly improved this week, supported by more benign economic data in the US and in Germany, the positive stance of the German Constitutional Court on the Greek bail-out, the fiscal measures adopted in Italy and the expectations of global policy coordination. In the US, ISM-Services increased to 53.3 in August, above July's level, suggesting that the service sector is continuing to expand, while industrial production and retail sales came in much better than expected. Nevertheless, uncertainties about global growth and the resolution of eurozone debt crisis remain high. In the US, the latest Beige Book report suggests that labour market weakness continues to weigh on the sluggish economic recovery. In this context, there is a great expectation about President Obama's jobs package, which is worth an estimated $300bn (at the time that this report was written, Mr. Obama has not yet started his speech). In Europe, there are still doubts around the scope and eventual effectiveness of the current stabilization mechanism (EFSF) to intervene in the markets and restore confidence. This suggests that it may be difficult to restore investor confidence in the near term, unless a coordinated policy is taken in light of the G-7 meeting this week and the IMF meeting in two weeks' time. Thus, we think the positive impact of a possible approval by the national parliament on EFSF's amendment will have a short-life.

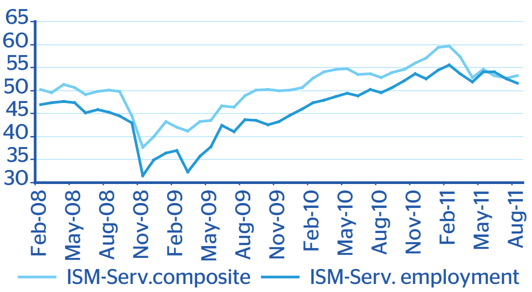
The ECB is not only signalling a "wait-and-see mode" but also an easing bias

The ECB has shown it concern over the economic situation, in line with other Central Banks. The ECB has revised downward its outlook for growth and has remarked that risks are on the downside. Eurosystem staff projections foresee annual real EZ GDP growth in a range between 1.4% and 1.8 % in 2011 and between 0.4 % and 2.4% in 2012. This compared with a previous range of 1.5% and 2.3 % in 2011 and between 0.6 % and 2.8% in 2012. Overall, the ECB's statement and press conference marked a shift to a wait-and-see stance (as expected) but leaned (more than expected) to the dovish side. Significant wording changes were reinforced by the tone of the press conference. It is our view that by doing that, the ECB is not only signalling a "wait-and-see mode" but also an easing bias. The ECB will likely embark on a prolonged monetary policy pause. However, by implicitly adopting an easing bias, it paves the way for a rate cut if downside risks to growth intensify further (see ECB watch).

Next week EC will release its economic forecast. Market will pay attention to a possible agreement on Finland's request for Greek collateral and to the informal ECOFIN meeting.

Chart 1

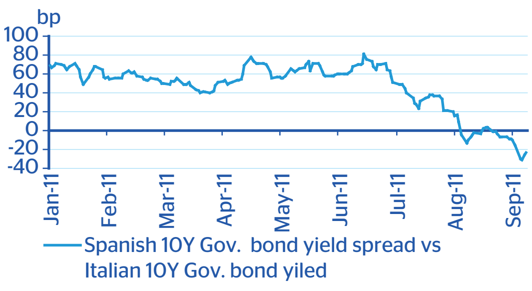
US Services sector continues to expand



Source: Bloomberg and BBVA Research

Chart 2

Uncertainties have turned to Italy



Source: Bloomberg and BBVA Research

Highlights

Eurozone 2Q11 GDP figures confirmed the weakness of the domestic demand...

... against expectations of a take over.

A broad look at monetary policy in Emerging Markets

EM Central Banks have reacted to the global uncertainties by halting their monetary tightening. Nevertheless, lower price pressures in Latam countries might support interest rate cuts in the region, while in Asia tightening may resume if uncertainties disappear.

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Markets

Peripheral countries and central banks will set the trends for interest rates markets

Interest rate markets have started September with very volatile performance, mainly driven by three factors: peripheral European countries, global growth and central banks' actions. With regard to central banks, if our anticipated scenario is confirmed we would expect to see the whole Eonia rate curve move above 75bp (deposit facility rate). In the US, the market will be focused on Bernanke's and Obama's speeches. These two statements may clear up doubts over whether the Fed will announce fresh stimulus measures or not once and for all, especially an "Operación Twist". Even so, in view of the current levels we do not see much potential for upwards or downward movement in the Treasuries curve.

SNB Effectively Pegs EURCHF at 1.20

On Tuesday, the Swiss National Bank (SNB) took the unprecedented step of marking CHF to the EUR at EURCHF 1.20. Given the severity of Tuesday's CHF move, we believe the SNB might have a decent shot of successfully defending EURCHF 1.20 in the weeks ahead although we note in this current global macro environment some bid for CHF is likely to remain and the SNB will likely need to be prepared to directly intervene in FX markets – possibly daily. We believe the result of Tuesday's announcement could be the cessation of the CHF as an outright safe-haven currency in the near-term.

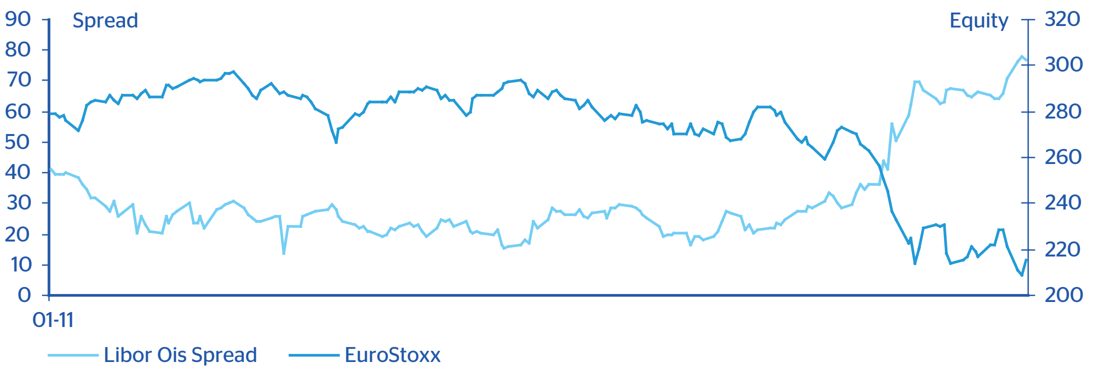
Credit markets pause

Following five consecutive days of widening, on Wednesday sentiment on credit markets improved, fundamentally following the ruling by the German Constitutional Court that the bailout deal was legal. This rebound was expected following the significant widening of the previous days. Before Wednesday the iTraxx Main had widened 80% YTD, most of which in the last few weeks. Despite the rebound, we do not expect this positive sentiment to continue, since the great uncertainties afflicting Europe have yet to be resolved.

A fresh rally on European equity markets… from two-year lows

Attacks on equity markets happen: first was European sovereign risk, then the global slowdown and now European bank funding. The problem of bank funding is not a problem with liabilities, but rather assets, and cleaning up assets. The global slowdown and European sovereign risk make this clean-up more challenging. While investors remain focused on these two factors (watching global macro data and national votes on the EFSF), and in the absence of new drivers (e.g. changing the liquidity criteria of Basel III, possibility of issuing EU-guaranteed bonds, etc), bank funding problems will remain, and with them pressure on equity markets.

Chart 3
Libor Ois Spread vs. EuroStoxx



Source: Bloomberg

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Highlights

Eurozone 2Q11 GDP confirmed weak domestic demand

Data confirmed a clear slowdown in activity, larger than anticipated (BBVA Research: 0.4% q/q; Consensus: 0.3% q/q) and after growing 0.8% in Q1. External demand continued to be the main growth driver, while domestic demand was weak, contradicting expectations that it could take over during first semester. Q2 growth was supported by net exports, contributing with 0.2pp as a result of exports growing at 1.0% q/q and a modest growth in imports (0.5% q/q), both slowing compared to Q1 (2.0% and 1.5%, respectively). The larger slowdown in imports reflected a fall in private consumption higher than our expectation, and a sharper slowing in investment. Change in inventories contributed positively with 0.1pp while public consumption fell by 0.2% q/q, as expected, after rising in Q1. As a result, domestic demand contribution was nil in Q2. Recent data showed more shadows on the economic situation in Q3. Recent data showed more shadows on the economic situation in Q3. In particular, our MICA model for short-term growth forecasts points towards a timid contraction in the current quarter, although so far it is only based on confidence indicators.

A broad look to monetary policy in Emerging Markets

With an increase in uncertainties to the global economic outlook, Central Banks in Asia appear to be taking a pause from further interest rate increases. The latest evidence came from the Bank of Korea, despite rising inflation—to 5.3% in August, well above the 2-4% target range—they left interest rates unchanged at 3.25%. The Central Bank flagged weakness in the outlook for developed economies, while still expressing confidence in the resilience of the domestic economy. Also this week, the Reserve Bank of Australia and Bank of Indonesia remained on hold at 4.75% and 6.75% respectively. As expected, Malaysia and the Philippines followed suit at their meetings today, in line with other central banks who appear to have shifted to pause, including the People's Bank of China (PBoC) and the Reserve Bank of India, both of whom had implemented aggressive tightening campaigns earlier this year. At the same time, Central Banks remain on alert for inflation, with Thailand's central bank hiking rates as recently as August 24, and the PBoC continuing to take steps to curb credit growth. Moreover, the stance of monetary policy across the region remains highly accommodative on the whole, and with inflation pressures persisting and growth so far proving surprisingly resilient, we expect tightening to resume if and when the global environment stabilizes. Currency appreciation is also expected to continue, especially given prospects of renewed capital inflows to the region.

Latin American Central Banks halted the monetary tightening, amidst new signs of global economic weakening and low inflation. They might even begin some relaxation as inflation remains low and the global economic situation deteriorates. Most countries will feel more constrained to apply fiscal stimulus due to lower commodity prices and already high levels of public expenditures. In this context, LATAM currencies might have reached a high water mark in this cycle, as evidenced by the weakening of the Brazilian Real and the pressures on the Argentine peso.

In the case of Eastern Europe, the initial reaction from Central Banks will be (is already in place) a "wait and see" attitude. Most will stop the monetary tightening but we do not see a significant easening as inflation remains relatively high in some of the countries. We see low margin for fiscal policy as the "Western Europe demo" effect is alive and because in these countries fiscal indicators are not as comfortable as in other EM areas, so it will be difficult to observe fiscal easening. On exchange rate, the natural situation (assuming the stop of the increase in interest rate differential) would imply lower appreciation pressures.

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Calendar: Indicators

Eurozone: Industrial production (July, September 14th)

Forecast: 0.5% m/m	Consensus: n.a.	Previous: -0.7% m/m

Comment: We expect industrial production to have increased in July, although not enough to offset the significant fall recorded in the previous month. Despite the rebound of July, industial production should be still at the same level of the average of Q2, after slowing significantly over H1 2011. Although this performance was somewhat expected after the strong recovery observed in 2010, the industrial sector has also been facing lower orders from abroad. More worrying signs came from confidence surveys, as they point to a possible contraction of the industrial sector in Q3. Nevertheless, after the strong rebound in German industrial production in July, we see some upside risks to our forecast. **Market impact:** A sharp decline in industrial production could increase concerns about a double-deep in the eurozone.

Eurozone: HICP (August, September 16th)

Forecast: 2.5% y/y	Consensus: 2.5% y/y	Previous: 2.5% y/y

Comment: We expect HICP inflation to be confirmed at 2.5% y/y in August for the second month in a row, as suggested by the flash figures. Core inflation should have remained broadly stable at 1.5% y/y, while inflation in more volatile components should also have remained relatively stable or even slowing timidly. Overall, we continue to see inflation rising slightly further the coming months, driven by a rebound in prices of non-energy industrial goods (especially in Italy). Going forward, headline inflation should moderate at the end of the year, driven by favorable effects in energy prices, to revert below the ECB target at the beginning of 2012. **Market Impact:** We do not think that inflation data should greatly affect markets, but a moderation in core inflation somewhat higher than expected combined with increased fears of double-dip could lead markets to price a more expansionary monetary policy in the coming months.

Retail Sales, Ex. Auto (August, September 14th)

Forecast: 0.2%, 0.3%	Consensus: 0.2%, 0.2%	Previous: 0.5%, 0.5%

Comment: The back-to-school shopping season likely had a positive impact on retail sales for August, and Hurricane Irene most likely contributed to a boost in sales of home supplies toward the end of the month. However, domestic and imported auto sales were down slightly in August, and lower crude oil prices may have led to a nominal decline in gasoline sales. As consumer confidence remains weak, we expect retail sales to continue growing but at a slower MoM pace. **Market Impact:** Sustained growth in retail sales may help ease market anxiety and offset concerns regarding weak consumer activity.

Consumer Price Index, Core (August, September 14th)

Forecast: 0.2%, 0.2%	Consensus: 0.2%, 0.2%	Previous: 0.5%, 0.2%

Comment: Consumer price inflation is expected to slow in August after rising gasoline and food prices led to a significant jump in July's headline inflation. Despite continuing increases in food prices, energy price declines in August should help bring headline inflation back to trend. In addition, core inflation appears to be moderating, with vehicle prices slowing as temporary factors dissipate. In general, continued weakness in economic activity is likely to curb significant consumer price pressures in the coming months. **Market Impact:** Deflation concerns are minimal, however larger-than-expected price increases could warrant discussion at the Fed's extended meeting next month.

India: Industrial Production for July (September 12th)

Forecast: 5.9%	Consensus: 6.2%	Previous: 8.8%

Comment: The coming week will be eventful for India as investors eye the July industrial output (IP) and August WPI inflation outturns for cues on the course of monetary policy when the RBI's meets on September 16. IP will be particularly important as headwinds from a worsening global macro environment alongside rising interest rates have resulted in a moderation in growth. We expect July IP growth to be supported by higher infrastructure output, but weighed by a high base coupled with a slowdown in price sensitive consumer goods sector. **Market impact:** A lower outturn would further aggravate the growth outlook and dent sentiment.

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			Close	Weekly change	Monthly change	Annual change
Interest Rates (changes in bps)	US	3-month Libor rate	0.34	1	6	4
		2-yr yield	0.19	0	0	-37
		10-yr yield	2.03	4	-22	-73
	EMU	3-month Euribor rate	1.53	-1	-2	65
		2-yr yield	0.48	-5	-30	-23
		10-yr yield	1.90	-11	-47	-44
Exchange Rates (changes in %)	Europe	Dollar-Euro	1.401	-1.3	-1.5	10.3
		Pound-Euro	0.87	-0.4	-0.6	6.1
		Swiss Franc-Euro	1.22	8.7	17.0	-5.8
	America	Argentina (peso-dollar)	4.21	0.1	1.2	6.5
		Brazil (real-dollar)	1.65	0.9	1.4	-4.1
		Colombia (peso-dollar)	1788	0.3	-0.8	-0.9
		Chile (peso-dollar)	463	0.6	-2.2	-6.6
		Mexico (peso-dollar)	12.48	1.0	0.9	-4.3
		Peru (Nuevo sol-dollar)	2.73	-0.1	-0.5	-2.4
	Asia	Japan (Yen-Dollar)	77.32	0.7	0.3	-7.7
		Korea (KRW-Dollar)	1075.18	0.9	-1.4	-7.7
		Australia (AUD-Dollar)	1.065	-0.2	4.9	15.3
Comm. (chg %)		Brent oil ($/b)	115.8	3.1	12.9	49.5
		Gold ($/ounce)	1849.3	-1.8	6.3	48.7
		Base metals	573.3	0.4	0.4	12.0
Stock Markets (changes in %)	Euro	Ibex 35	8205	-3.1	-2.7	-23.4
		EuroStoxx 50	2159	-2.8	-5.9	-22.4
	America	USA (S&P 500)	1200	2.2	2.4	8.7
		Argentina (Merval)	2871	0.0	0.2	18.1
		Brazil (Bovespa)	58163	2.9	13.7	-12.7
		Colombia (IGBC)	13563	0.8	3.6	-5.6
		Chile (IGPA)	20101	-1.1	4.4	-8.7
		Mexico (CPI)	35168	0.1	8.6	8.1
		Peru (General Lima)	20118	-1.6	4.7	27.1
		Venezuela (IBC)	99806	-0.3	7.1	52.9
	Asia	Nikkei225	8793	-1.8	-1.7	-3.4
		HSI	19913	-1.5	3.0	-5.9
Credit (changes in bps)	Ind.	Itraxx Main	175	10	33	68
		Itraxx Xover	718	23	125	235
	Sovereign risk	CDS Germany	79	0	-4	38
		CDS Portugal	1037	61	176	710
		CDS Spain	369	-23	20	134
		CDS USA	51	-1	-2	---
		CDS Emerging	280	-2	4	27
		CDS Argentina	833	17	89	-55
		CDS Brazil	152	2	0	27
		CDS Colombia	152	3	1	21
		CDS Chile	101	5	12	25
		CDS Mexico	151	2	-2	10
		CDS Peru	157	3	-5	31

Source: Bloomberg and Datastream

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