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Weekly Watch
Global

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Economic Analysis

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US is key to the global outlook

The global growth risk factor that was initially focused on a possible hard landing in China is being increasingly driven by the soft-spell in the US economy. This week has been quite light in terms of macroeconomic data releases in developed countries. However, the Fed Chairman's confirmation that the US economy is losing momentum, together with the weaker than expected US economic data have brought the US economic slowdown into the spotlight as the main risk for the global growth outlook. The debate about the US economy can be broken down into two possible scenarios: in the first, the slowdown is expected to be temporary; and in the second, a double-dip is considered likely unless new stimuli are put in place. This has intensified the debate over whether QE3 is needed (see highlight). In this context, the global risk premium will be data-dependent and we do not expect new monetary policy guidance until the end of August (at Jackson Hole).

On the monetary policy front, the ECB hinted for a rate hike in July and extended the full allotment liquidity provision for refinancing operations during 3Q (see highlight), while the Bank of England made no changes to its monetary policy stance. In Asia, several central banks are beginning to signal a softer stance on inflation. In contrast, the Bank of Brazil hiked interest rates (25bp) and hinted that another hike was possible.

Private sector involvement seems unlikely in the short-term

There is a lot of noise regarding the involvement of private investors in the second Greek aid package. Germany is still wants private investors to extend their Greek debt maturities, while the ECB insists that any private-investor involvement should be strictly voluntary and should not trigger a credit event. In this context, a private-investor bail-in seems quite unlikely in the short-term, something which is in line with our baseline scenario. In our opinion, after the good assessment of the "Troika", the EU is likely to support a second aid package for Greece if the Greek parliament is not able to approve the Medium-Term Fiscal Strategy programme. The ECOFIN meeting on 20 June will be focused on the European Countries Stability & Growth Programme and perhaps on Greek aid package, and thus may potentially add uncertainty and impact the sovereign risk perception.

Next week: May CPI figures will be released in the US, China and Europe. Additionally, May industrial production will be published both in China and the US.

Chart 1
Spanish 10Y bond Spread vs Italian bond (bp)

Source: Bloomberg

Highlights

QE3 is not on the Fed's mind
Weaker than expected data has sparked talk about the possibility of additional quantitative easing.

The ECB signals a July increase
The fact that the ECB is preparing to hike rates despite problems in Greece shows its pro-active approach towards inflation risks

The IMF & EU's financial programme for Portugal
The programme is better-designed than the Greek one, but does entail some financial risks.

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Markets

Currencies continue to fluctuate in response to cyclical and sovereign risk premiums

As has happened since mid-May, over the last week the performance of global currencies was determined by cyclical risk premiums in the US, sovereign risk premiums in peripheral European countries, and expectations with regards to ECB monetary policy. However, on this occasion there was a change in the trend in the dollar due to worse than expected economic indicators. The US currency thus appreciated strongly vs. most other currencies (of developed and emerging markets), again playing the role of a safe haven (in fact, the JPY was one of the few currencies which strengthened over the course of the week).

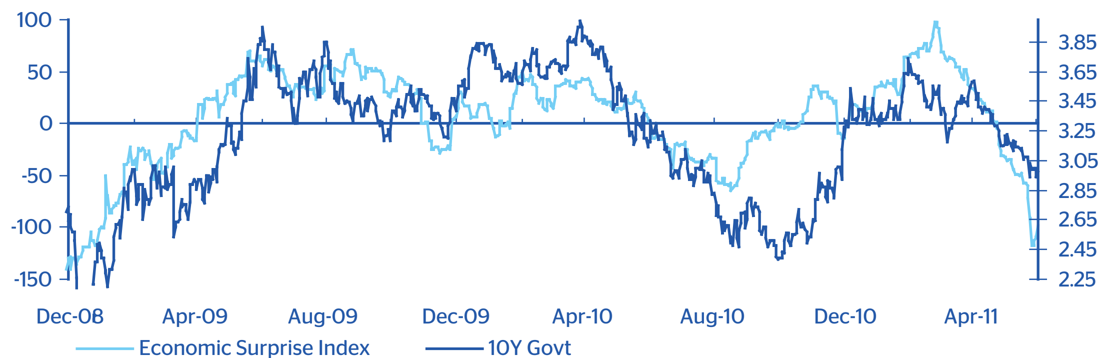
US curve in free fall

The treasury curve remains strongly linked to growth figures. The recent increased sensitivity of rates to macroeconomic data, together with the deterioration of said data (especially employment), has resulted in major downward pressure on the whole US curve. Within this movement there are three noteworthy factors: i) short-term rates and the monetary curve have reached levels similar to Novemeber 2010 when QE2 was announced, and it is particularly significant that the 3-month USD Libor is already below 0.25%, the FED benchmark rate; ii) the movement has been particularly marked in the belly of the curve, with the 5-7Y tranche suffering in particular, and; iii) downward pressure is greater on nominal rates than real rates, leading to an easing of expected inflation measured by break-evens. These new levels have been confirmed by the market through auctions in the 3Y, 10Y and 30Y tranches for which there was a good level of demand, apparently indicating that rates will remain in this range in the coming weeks. Major positive surprises would be needed from cyclical indicators for rates to break above their current ranges.

OPEC fails to reach an agreement to increase production quotas

At a tense meeting, due to the open confrontation of various countries, no agreement was reached to set new production quotas. The proposal from Saudi Arabia, supported by Qatar, Kuwait and the United Arab Emirates to increase current production by 1.5 million b/d from the current 28.8, was rejected by the bloc led by Iran and Venezuela. The market's reaction to this news was swift, in the form of a two-dollar rise, although in our view market conditions remain unchanged. Almost all of the idle capacity is in Saudi Arabia, and the country has shown its willingness to step up production if there is a spike in demand, regardless of its agreements with OPEC. In any case, since this increase in production would be a response to improved demand, it could even put pressure on oil prices, since there is less and less capacity to absorb a shock in supply such as the one in Libya (and the unrest in the MENA region remains very present). In terms of demand, the slowdown in global industrial activity is worrying, although in the last two weeks US petrol consumption has been better than expected. Our forecasts suggest that oil will remain range-bound at USD110-120 for at least a couple of months, in view of the geopolitical premium which is still very present in the market.

Chart 2
10Y treasury and economic surprise index



Source: Bloomberg and BBVA Research

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Highlights

QE3 in the US is not on the Fed's mind

Recent economic indicators have proven weaker-than-expected, suggesting a sharper and wider spread deceleration. This has led to talk about additional quantitative easing (QE3) once QE2 finishes at the end of June. However, the Fed is unlikely to make such a move if the net benefit of QE3 is perceived negative. First, although data has been weak, the economy continues expanding. Second, the duration of the current slowdown is highly uncertain. Third, deflationary risks are nowhere on the horizon and finally, financial markets are functioning more normally. Thus, the FOMC will wait until new data provides a clearer view on the downside risks confronting the economy. As we move into a hot summer, the Fed will end QE2 as planned, continue reinvestment of principal payments on holdings of securities, keep the discussion on the exit strategy on hold, and evaluate additional monetary tools in case they become necessary.

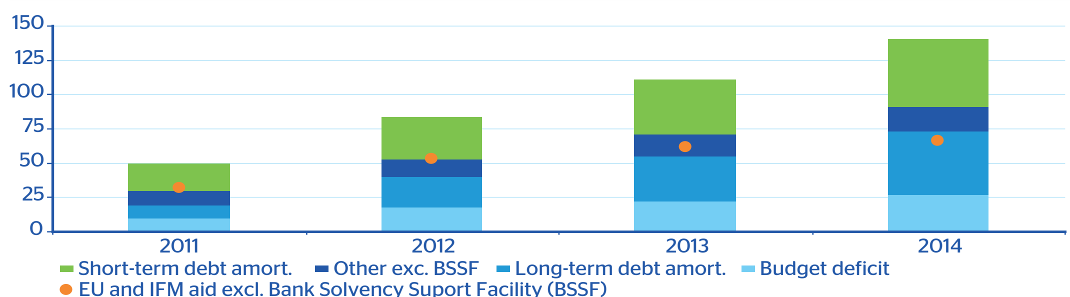
The ECB signals a July increase

The ECB monetary policy meeting did not bring any surprises. "Strong vigilance" on upside inflation risks wording was used –thereby signalling a 25bp rate hike in July– and the fixed rate "full allotment" was extended to 3Q. The fact that the ECB is preparing to hike rates in July, despite the acute problems in Greece, shows that the ECB maintains a pro-active approach towards inflation risks to avoid an unwelcome increase in inflation expectations. Furthermore, recent comments from members have been on the hawkish side and have signalled that "if the economy continues to grow" more gradual moves are likely as "the very low level of interest rates that we have does not seem fully justified" (Bini Smaghi) and therefore "there is now a greater need to proceed with monetary policy normalisation so as to prevent expectations of higher inflation from becoming entrenched". Overall, recent events along with yesterday's hint of a 25bp July hike reinforce our view that the ECB might bring forward the hikes which we expect for early 2012 (in January and April), taking official rates to 1.75% by year-end and to 2.0% by 1Q 12. With respect to Greece, the ECB's strong position against restructuring was reiterated. The ECB excludes anything that is not absolutely voluntary and that would trigger a credit event. The Governing Council has no choice but to strongly oppose any kind of restructuring that is "not purely voluntary" in order to influence other decision-makers. For the ECB, it would be an "enormous mistake to embark on a decision that would trigger a credit event" i.e. they see no difference between "soft" restructuring and restructuring given that the impact (contagion) is the same.

The IMF & EU financial programme for Portugal

The IMF and EU financial programme for Portugal is based on a conservative macroeconomic scenario, which assumes a contraction of Portuguese GDP growth by 2% over 2011 and 2012, and a gradual recovery after 2013. The programme projects a total Portuguese financing gap of EUR78bn throughout 2011-2014. This will be covered in a ratio of 2 to 1 by the European Union and the IMF, as was the case for Greece and Ireland. The EU-IMF financing aid includes EUR12bn to the Bank Solvency Support Facility (BSSF). The programme addresses the difficulties that Portugal faces in financing its debt in markets. It assumes significant falls to an average of 50 percent in rollover rates on government debt in 2011-2012 from an average of about 130 percent in 2008-2010. Furthermore, the IMF programme assumes that Portugal will not access financial markets to finance its long-term debt in 2012. The IMF programme also projects a gradual return to markets for medium and long-term debt, with access fully restored by 2014 which is the last year of the programme. Our view is that the programme is better-designed than the Greek programme because the EUR78bn (EUR66bn without bank support) EU-IMF aid package is enough to cover the Portuguese public deficit and long-term debt amortisation until 2013 (inclusive). Yet, the main risk is a closure or contraction of financing in short-term maturities. However, Portugal will also need to access markets in 2013 for long-term refinancing in order to finance part of the bank restructuring and other costs that are not included in the BSSF. This also entails some risks for a country with considerable structural problems which look set to take time to resolve.

Chart 3
Portugal: estimated public financing needs and IMF+EU loan under the current program, bn € accum



Source: IMF

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Calendar: Indicators

Eurozone: Industrial production (April, June 15th)

Forecast: 0.4% m/m	Consensus: 0.1% m/m	Previous: -0.1% m/m

Comment: We expect industrial production to have increased slightly again in April, after having stagnated in the previous month. Nevertheless, soft data continues to suggest that the industrial recovery should proceed at a slower pace in the coming months following the strong momentum observed over the last year. In addition, the industrial sector, especially in equipment and intermediate goods, should continue benefiting from the robust demand of emerging economies. Overall, available data showed further evidence that it has already reached the cyclical peak. **Market impact:** a very negative surprise could be interpreted by markets as slower than expected economic growth.

Eurozone: Final HICP inflation (May, June 16th)

Forecast: 2.7% y/y	Consensus: 2.7% y/y	Previous: 2.8% y/y

Comment: We expect headline inflation to be confirmed at 2.7% y/y in May, slowing by 0.1pp vs. the previous month, mainly due to a moderation of energy inflation as fuel prices have continued to moderate in recent weeks. In addition, our projections suggest that core inflation should have remained stable at around 1.8% y/y in May. Nevertheless, we think that May's deceleration could be short-lived, as we still expect headline inflation to increase slightly over the coming months, reaching close to 3% y/y in 3Q, before then beginning to drop. **Market impact:** a further acceleration in core inflation could increase market concerns about higher indirect effects that could result in a tighter monetary policy in order to avoid both second-round effects and the de-anchoring of inflation expectations.

US: Retail Sales (May, June 14th)

Forecast: -0.4% m/m	Consensus: -0.3% m/m	Previous: -0.5% m/m

Comment: Retail sales remained robust, increasing by 0.5% MoM in April and having increased over the last ten consecutive months. Unnerving non-farm payroll data and declining consumer confidence present significant downside risks to retail sales figures for May. Moreover, disappointing auto sales, a slight decline in gas prices and relatively small increase in consumer prices could drag down retail sales in May. **Market impact:** an increase in retail sales would eliminate some of the recent pessimism in the economy and boost stock prices.

US: Consumer Price Index, Core (May, June 15th)

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

Comment: Inflationary concerns persist as the CPI in April rose by 0.4% MoM. The energy and food price indexes continue to drive up consumer prices. The energy and food indexes have increased 19.0% and 3.2% respectively over the last 12 months. Core CPI remains subdued, growing at 0.2% MoM in April, in line with slow employment growth and large economic slack. Due to the slight decline in oil and gas prices, we do not expect any changes in headline consumer prices in May. **Market impact:** if consumer prices decline significantly it would not only show the impact of declining energy prices, but also the sharp slowdown in economic activity. This would affect equity prices negatively.

China: CPI (May, June 14th)

Forecast: 5.6% y/y	Consensus: 5.5% y/y	Previous: 5.3% y/y

Comment: Headline inflation in May is likely to climb further as food prices, which had shown signs of easing in recent months, are once again accelerating due to the ongoing drought in southeast China. Non-food components are continuing to rise as well. We expect inflation to peak in June, before declining to 4.0% y/y by the end of the year as commodity prices ease and ongoing monetary tightening measures take effect. **Market impact:** a lower-than-expected reading could bolster market sentiment, which has been weak due to expectations of further tightening and slowing growth, while a higher-than-expected reading would do the opposite..

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Markets Data

			Close	Weekly change	Monthly change	Annual change
Interest Rates (changes in bps)	US	3-month Libor rate	0.25	0	-1	-29
		2-yr yield	0.40	-2	-14	-33
		10-yr yield	2.97	-2	-19	-27
	EMU	3-month Euribor rate	1.46	3	4	75
		2-yr yield	1.59	-10	-21	112
		10-yr yield	3.01	-5	-12	44
Exchange Rates (changes in %)	Europe	Dollar-Euro	1.445	-1.2	1.6	19.8
		Pound-Euro	0.89	-0.3	2.2	6.9
		Swiss Franc-Euro	1.22	-0.4	-3.4	-12.4
	America	Argentina (peso-dollar)	4.09	0.0	0.2	4.2
		Brazil (real-dollar)	1.58	0.7	-2.3	-12.4
		Colombia (peso-dollar)	1771	-0.6	-1.7	-8.0
		Chile (peso-dollar)	466	-0.3	-0.3	-13.2
		Mexico (peso-dollar)	11.80	1.4	1.5	-7.1
		Peru (Nuevo sol-dollar)	2.76	0.1	-1.2	-2.9
	Asia	Japan (Yen-Dollar)	80.06	-0.3	-1.0	-12.6
		Korea (KRW-Dollar)	1084.30	0.8	0.3	-13.1
		Australia (AUD-Dollar)	1.060	-1.5	-1.1	25.0
Comm. (chg %)		Brent oil ($/b)	119.4	3.1	6.1	60.6
		Gold ($/ounce)	1542.6	0.0	2.8	25.8
		Base metals	604.7	-0.7	0.3	27.1
Stock Markets (changes in %)	Euro	Ibex 35	10055	-2.2	-4.5	5.2
		EuroStoxx 50	2759	-1.1	-6.2	4.6
	America	USA (S&P 500)	1289	-0.9	-4.0	18.1
		Argentina (Merval)	3233	2.1	-4.5	41.7
		Brazil (Bovespa)	63469	-1.4	-0.5	-0.2
		Colombia (IGBC)	14424	-0.1	1.6	17.2
		Chile (IGPA)	22559	-1.9	-1.7	22.2
		Mexico (CPI)	35233	0.3	-0.4	9.7
		Peru (General Lima)	20953	-1.3	1.1	47.4
		Venezuela (IBC)	80104	-0.5	3.3	25.8
	Asia	Nikkei225	9514	0.2	-3.5	-2.0
		HSI	22400	-2.4	-3.8	12.7
Credit (changes in bps)	Ind.	Itraxx Main	106	2	9	-24
		Itraxx Xover	390	4	35	-207
	Sovereign risk	CDS Germany	39	2	0	0
		CDS Portugal	720	55	81	431
		CDS Spain	259	22	15	53
		CDS USA	50	3	8	---
		CDS Emerging	216	-4	10	-69
		CDS Argentina	602	-17	7	-507
		CDS Brazil	111	2	7	-31
		CDS Colombia	104	2	3	-59
		CDS Chile	70	1	10	-35
		CDS Mexico	106	1	8	-34
		CDS Peru	143	-2	4	3

Source: Bloomberg and Datastream

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