Global

Weekly Watch

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Economic Analysis

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Efforts to curb inflation in EM

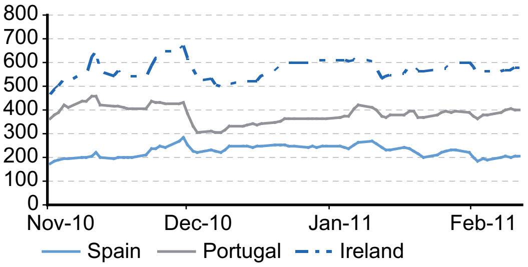
Consumer prices data released this week suggest that inflation pressures continue in emerging markets (EM). In Brazil, inflation figures rose to 6%. Additionally, Banxico announced that inflation will remain between 3-4% in the next two years, while pointing out some upside risks to its forecast. In this context, EM central banks are increasing their efforts to curb inflation. In this regard Chinese, Indonesian and Peruvian central banks raised interest rates by 25bp. Although the rate hike in China was in line with our expectations (we forecast two more hikes in 2011), the fact that this movement comes ahead of next week's release of January activity and price indicators suggests some preventive action to reduce overheating. Also, spending cut measures taken by the Brazilian government are welcome because they complement counter-cyclical monetary policy efforts and reduce interest rate hike expectations. All this confirms our baseline scenario of a "soft landing" in EM and a moderate recovery in developed markets (DM) supported by foreign demand. .

Communication fine-tuning in DM central banks

During the last two weeks comments from Fed officials remained dovish, especially when long-term interest rates were close to dangerous levels, reducing the probability of early rate hikes in the short-term. Bernanke insisted that inflation remains subdued and that there is a need to address the long-term deficit problem. Meanwhile, ECB talk continues to be all about prevention and the hawkish tone has not been stressed further. Once again financial strain has appeared in European peripheral countries, although so far Spain has not been affected. Uncertainties about how the new Irish government will confront the banks' bail-out have been the main driver. But above all, the situation shows that concrete measures to support the euro's stability and resolve the solvency problems in the area are urgently needed. We hope that the competitive issues that will be addressed in the next UE council meeting on March 11th will not cloud the reinforcement of the EFSF mechanism. An announcement on that matter is expected on March 25th.

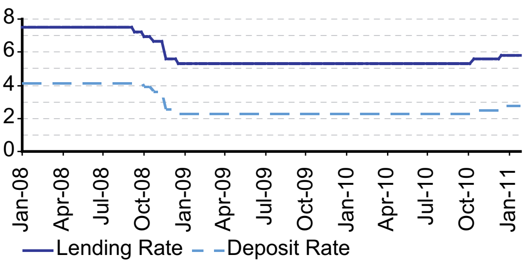
Next week will be very busy on the macro front. In the US, January retail sales and CPI, among other indicators, look set to suggest an improvement in domestic demand without a significant turning point in underlying prices. In the Eurozone, 4Q GDP should confirm the growth recovery led by foreign demand. In EM all eyes will be on China's inflation, credit growth and activity data. They may give some clues about whether tightening has been effective in reining in the overheating.

Chart 1
10Y Government Spread vs. German Bond



Source: BBVA Research

Chart 2
China Interest Rates



Source: BBVA Research

Highlights

Impact of crude prices on Eurozone Inflation
Brent barrel at $100 would raise annual inflation by about 0.3pp in 2011 to 2.2%.

Keep an eye on the high US deficit
The persistence of a high deficit could impact the long term yield.

Spanish fiscal consolidation is on track
Control mechanisms have been put in place to ensure the consolidation path.

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Forex: Positioning Key to Near-term Outlook

With the peripheral Eurozone debt situation at a bit of a lull and a lot of positive news already priced in, the FX market finds itself quite short of USDs. the latest CFTC data suggests that some funds and Commodity Trading Advisors are actually quite short of USDs on an aggregate basis versus the most liquid currencies compared with historical levels (see chart). Typically, when market positions become so one-sided with USD shorts, a number of potential outcomes are worth highlighting. Firstly, a large appreciation in other major currencies (EUR, GBP, MXN, etc.) over the short-term becomes somewhat unlikely due to the notion that the market is already at extreme levels and speculators are unlikely to push further. Secondly, if there is an appreciation in non-USD currencies, the pace of appreciation is usually slow and choppy. This is because most speculators are already long currencies versus USDs, have the trade on, are unwilling to add to the position and are often looking to book profits when possible. Third and finally, the risks for short-term USD appreciation have increased based on the notion that the extreme number of USD short positions, if squared, would likely have a “domino affect” on other outstanding positions and eventually prices. To square those USD shorts in this market would likely require a macro impetus that causes a material fall in risk appetite across global asset classes – triggering a rush to safe-haven assets and currencies and causing a bid for USDs.

With oil prices stable post-Egypt and our macro team expecting the peripheral Eurozone debt situation to be resolved successfully, we believe FX markets are biased towards further consolidation in the coming weeks given current positioning. If the global macro environment suddenly materially deteriorated, USD appreciation would likely be exacerbated.

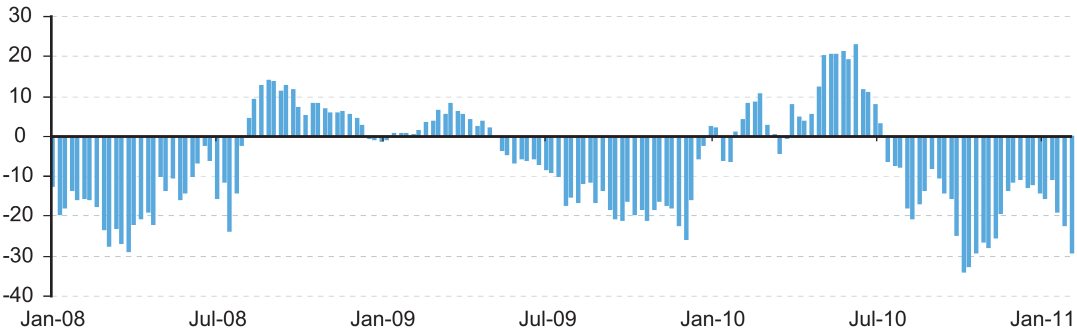
Interest Rates: Commodities have retained their momentum, but breakevens have reacted much more moderately of late

The breakevens in the US and euro curves have priced in the recent context of a growing focus on inflationary risks mainly resulting from the appreciation of commodities. This effect was particularly marked in December 2010 and early January 2011, with rises of around 50bps in the US 5Y to 240bps and euro 5Y to 200bps (in the case of the latter measured via the breakeven in French inflation). Since then, even though commodities have retained their momentum, breakevens have reacted much more moderately (and have even dropped somewhat). This profile may be reflecting some capacity for the market to cushion some of the impact commodities may finally have on price indexes in the long term. Also, this decreased dynamism may also reflect the fact that breakevens are already very close to the top end of the range they have been in since 2008. More aggressive breaches of these levels would have to form part of a much more urgent sense of inflationary risk in OECD countries, a situation which we think is a remote possibility during this phase of cyclical recovery, which has not yet come to an end.

Credit: Widening of financial tenors

The widening of financials reflects renewed concerns on European peripheral sovereign risk. The iTraxx SovX corrected somewhat following news that the European Central Bank intervened in government bond markets for the first time in three weeks to buy Portuguese debt amid fears that the country will be forced to follow Greece and Ireland in seeking an international bail-out; but it increased 5 bps in the week. The primary market continues to be buoyant with Iberian corporates, EDP and Telefónica’s new issues tightening by ca. 30-40bps.

Chart 3
Net CFTC Non-Commercial USD Position (Billions of USD)



Source:CFTC and BBVA Research

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Highlights

Impact of crude prices on Eurozone Inflation

After inflation accelerated in the last quarter of 2010 due to higher energy prices, reaching 2.4% in January, the hot question is if second round effects will arise. We have assessed the potential risks to our inflation forecast for the eurozone if the price of Brent remains at $100 instead of reverting to $88 at the end of 2011 (as in our baseline scenario). The direct effect on inflation through the energy component of HICP would be about 0.2pp and relatively short-lived. In contrast, the impact of both indirect effects (due to more expensive production inputs) and second round effects (due to higher wages) is more persistent due to its slower transmission mechanism. In order to assess these effects, we have simulated the impact of an oil price increase of around 15% on core inflation through a VAR model and found a small effect of only 0.1pp over the first year, and effect that lingers over the second year and dampens afterwards. All in all, a Brent barrel at $100 would raise annual inflation by about 0.3pp in 2011 to 2.2%. We do not think the ECB would be worried enough by such a temporary effect so as to hike interest rates. A different matter is that the ECB maintains a hawkish tone regarding commodities prices, precisely because it wants to avoid increasing price expectations. If the price of Brent were to rise to around $130, however, as it did in mid-2008, the effect on 2011 average inflation would be more significant, of about 0.6pp.

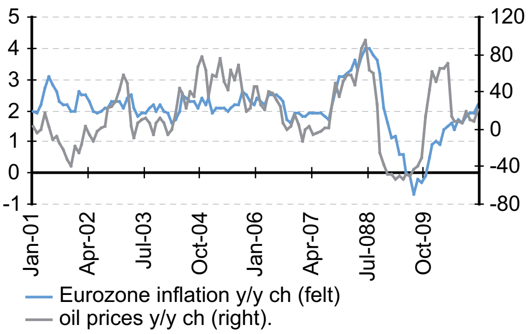
Keep an eye on high deficit

The expected debt to be reached in the US over the next five years is not significantly different from that of the Eurozone. The deficit will be even larger at least until 2015. Yet financial markets have not been punishing the US as they have Europe. However, as can be seen in our Global Economic Outlook, some studies for the US show that historical yields go up when deficit and debt increase. Particularly, an increase in public debt of 1% of GDP is associated with an increase in long-term rates of between 3 and 5bps, while a permanent increase in deficit by 1% of GDP tends to increase rates by between 18 and 67bps. Given that public debt and deficit in the US are projected to increase by 42% of GDP and by 3.8%, respectively, from 2007 to 2015, and taking into account that rates have actually fallen by 180bps since 2007, the potential increase in the long run of the long-term rates could be on a range between 250 and 400bps from current levels. Although there are several reasons that justify the lower market pressure on the US versus Europe, one should not forget past lessons. US officials have warned about the impact on yields if high debt and deficit persist. This week, Bernanke called for a reduction in fiscal policy while Obama pledged to cut spending. The next step will be the president's announcement of the 2012 budget by mid-February.

Spanish fiscal consolidacion is on track

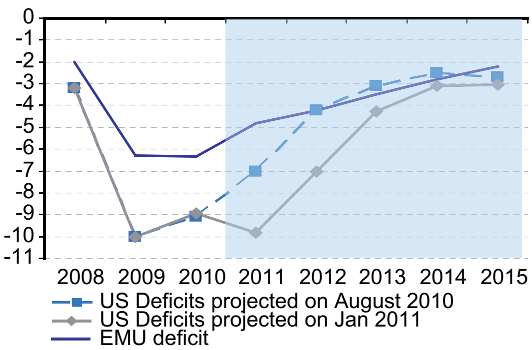
The consolidation of public finances remains one of the most important factors to ensure investor confidence. In this regard, in line with what was stated in the Spain Outlook review, Spanish public finances not only met budget targets, but also control mechanisms have been put in place to ensure the future path. The figures at the end of 2010 released by the State confirm that it easily fulfilled its stability goal, which virtually guarantees that the total deficit target of -9.3% of GDP will be achieved, even assuming some upside risk on the deficit of the autonomous communities. Also it is expected that the deficit will decrease to 3% of GDP in 2013. Autonomous communities manage 40% of the Spanish public spending and for the first time this year their funding is focused on tax revenues, which reduces government transfer payments. Therefore, in order to meet the deficit target, it is necessary that all autonomous communities strictly conform to the target of 1.3% of GDP in 2011. The task is not easy given the degree of heterogeneity between communities. Therefore the implementation of control mechanisms is very positive, including, in addition to the authorizations for the issuance of new debt (only if the amount does not exceed 1.3% of GDP), the requirement that an adjustment plan be drafted to return to the path of fiscal stability. However, we believe that the regional public debt will fall below 14% of GDP in 2011, far from the levels recorded by other regions with similar credit ratings.

Chart 4
Eurozone Inflation and Oil Prices



Source: BBVA Research

Chart 5
US and EMU Public Deficits



Source: CBO and BBVA Research

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Calendar: Indicators

Eurozone: Industrial production (December, February 14th)

Forecast: 0.1% m/m	**Consensus:** -0.2% m/m	**Previous:** 1.2% m/m

Comment: Released national figures suggest that industrial production in the eurozone was virtually flat in December, after increasing by 1.2% m/m in November. Overall, average data for Q4 suggest that the industrial recovery gathered pace at the end of last year, supported by the resilience of global demand. Other soft data also paint a similar outlook, after the ongoing improvement in business confidence, driven by strong export orders. **Market Impact:** No large surprises are expected, given the release of national indicators.

Eurozone: GDP Flash Estimate (Q4, February 15th)

Forecast: 0.5% q/q	**Consensus:** 0.4% q/q	**Previous:** 0.3% q/q

Comment: Short-run data available for Q4 suggest that economic activity in the eurozone gained momentum at the end of 2010. Once again, the recovery should be led by Germany (0.7%) and France (0.5%), while Italy (0.2%) could have slowed somewhat. In contrast, both Portuguese and the Greek output could have contracted significantly. We consider this forecast's risks to be tilted slightly to the downside, as German economic growth could have been slightly lower as a consequence of a severe winter. **Market Impact:** Markets could react negatively to slower economic growth than expected in a context of still high uncertainty surrounding periphery countries.

US: Industrial Production (January, February 16th)

Forecast: 0.5% m/m	**Consensus:** 0.6% m/m	**Previous:** 0.8% m/m

Comment: According to the Federal Reserve's estimate, U.S. industrial production (IP) rose 0.8% in December. While production in the manufacturing sector increased by 0.4%., severe cold weather in December increased demand for utilities, and therefore the output of utilities soared 4.3%. With strong growth in December production, the total capacity utilization rate reached 76%. The capacity utilization rate in utilities jumped more than 3pp and reached 82.3%. Recent regional Fed surveys indicate that manufacturing activity remains robust and, we therefore expect IP to continue increasing in January. However, inflationary pressures are expected to remain contained due to the low total capacity utilization rate. **Market impact:** Stronger-than-expected industrial production activity would indicate robust economic growth in 1Q11 and push equity prices even higher.

US: Consumer Price Index (January, February 17th)

Forecast: 0.3%, 0.1% m/m	**Consensus:** 0.4%, 0.1% m/m	**Previous:** 0.5%, 0.1% m/m

Comment: In December, headline and core consumer price indices increased by 0.5% and 0.1% MoM, respectively, on a seasonally-adjusted basis. Energy prices were the main driver of increase in headline prices. The energy index jumped 4.6% in which the gasoline index hiked 8.5% and accounted for 80% of the all items increase in December. Although deflationary pressures remain elevated in core consumer prices, shelter prices are curtailing some of these pressures. With the latest figures, headline and core consumer prices rose 1.6% and 1.0% in 2010, respectively. We expect core inflation to remain low but positive in 2011. Furthermore, we expect a slowdown in headline inflation in January given a slowdown in the increase in energy prices. **Market impact:** Upward surprise in core prices would welcome by the Fed and markets and decrease deflation fears significantly.

China: CPI (January, February 15th)

Forecast: 4.9% y/y	**Consensus:** 5.4% y/y	**Previous:** 4.6% y/y

Comment: Headline inflation is expected to pick up again after a temporary easing in December. Adverse weather conditions (including cold weather and drought conditions in China's North) are expected to have led to further increases in food prices, although recent weekly indicators show overall increases to be relatively modest. That said, pressure on non-food components is also on the rise. **Market impact:** An outturn higher than the market consensus (already high at 5.4%) could undermine sentiment by generating expectations of even more aggressive monetary tightening, and raising questions about the authorities' ability to achieve an economic soft landing.

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				Close	Weekly change	Monthly change	Annual change
Interest Rates	(changes in bps)	US	3-month Libor rate	0.31	0	1	6
			2-yr yield	0.79	5	19	-3
			10-yr yield	3.61	-2	25	-8
		EMU	3-month Euribor rate	1.09	0	10	43
			2-yr yield	1.39	-5	41	41
			10-yr yield	3.27	0	21	7
Exchange Rates	(changes in %)	Europe	Dollar-Euro	1.356	-0.2	3.6	-0.5
			Pound-Euro	0.85	0.4	2.0	-2.6
			Swiss Franc-Euro	1.32	1.3	3.7	-10.2
		America	Argentina (peso-dollar)	4.02	0.1	1.2	4.3
			Brazil (real-dollar)	1.67	-0.6	-0.6	-10.5
			Colombia (peso-dollar)	1879	0.4	0.6	-2.9
			Chile (peso-dollar)	473	-1.2	-3.5	-10.4
			Mexico (peso-dollar)	12.06	0.6	-0.1	-7.0
			Peru (Nuevo sol-dollar)	2.76	-0.1	-0.9	-3.1
		Asia	Japan (Yen-Dollar)	83.34	1.1	0.2	-7.3
			Korea (KRW-Dollar)	1122.50	1.9	1.1	-3.2
			Australia (AUD-Dollar)	1.001	-1.0	0.7	13.0
Comm.	(chg %)		Brent oil ($/b)	101.5	1.7	3.4	39.2
			Gold ($/ounce)	1367.2	1.4	-1.5	25.0
			Base metals	616.6	0.7	4.0	29.9
Stock Markets	(changes in %)	Euro	Ibex 35	10756	-0.9	6.5	5.2
			EuroStoxx 50	3015	0.4	4.7	12.7
		America	USA (S&P 500)	1321	0.8	2.7	22.8
			Argentina (Merval)	3414	-6.0	-5.2	50.2
			Brazil (Bovespa)	65299	0.0	-8.8	-0.8
			Colombia (IGBC)	14463	-1.1	-4.7	26.1
			Chile (IGPA)	21648	-1.5	-5.7	23.7
			Mexico (CPI)	36552	-2.4	-3.7	17.9
			Peru (General Lima)	22867	-3.5	1.0	60.1
			Venezuela (IBC)	66282	-0.6	0.7	16.5
		Asia	Nikkei225	10606	0.6	0.9	5.1
			HSI	22829	-4.5	-5.4	12.6
Credit	(changes in bps)	Ind.	Itraxx Main	97	2	-8	7
			Itraxx Xover	398	-4	-20	-97
		Sovereign risk	CDS Germany	53	0	-6	9
			CDS Portugal	440	35	-73	247
			CDS Spain	236	13	-96	104
			CDS USA	46	-1	5	---
			CDS Emerging	218	7	17	-65
			CDS Argentina	614	31	61	-461
			CDS Brazil	120	7	14	-19
			CDS Colombia	122	8	16	-45
			CDS Chile	83	8	2	7
			CDS Mexico	122	7	12	-19
			CDS Peru	118	11	13	-24

Source: Bloomberg and Datastream

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