Global

Weekly Watch

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Economic Analysis

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Renewed concerns on peripherals

Spreads between "periphery" and core interest rates have been widening once again this week on increasing worries that a "comprehensive solution" for the financial stability framework to address the Eurozone debt crisis is not ambitious enough. With the likely lack of progress during this week's Euro Summit (which is taking place while closing this note), it will be crucial to reach a consensus at the European Summit on March 24-25. Moreover, scepticism about the toughness of the scenario assumptions in the new European Stress Test (to be published on March 18) has not helped. Spain remains relatively unpunished, although Moody's downgraded Spanish sovereign debt by one notch to Aa2 and retained its negative outlook. However, the Portuguese 5 and 10 year bond yields are at similar levels (about 7.6%) to those of Ireland and Greece when they were rescued. In this context, the Portuguese government has announced additional fiscal consolidation measures (by 0.8% of GDP) to ensure that this year's target deficit of 4.6% is achieved, while providing more details of the measures to achieve fiscal targets for 2012 and 2013. The EU supports this package, but doubts remain on whether it will be enough to counter market pressures.

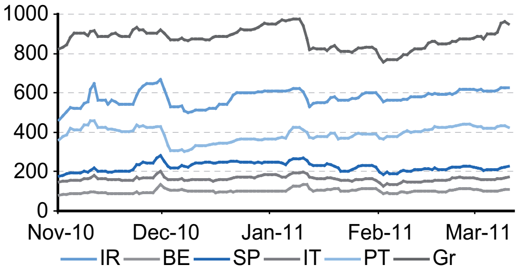
Geopolitical Risk remains high, although recovery is ongoing

There have not been any signs of improvement. Unrest in Libya could drag on for several months and the risk of it spreading to other MENA countries remains present. On the oil market, a 700,000b/d increase in Saudi Arabian production has been announced; on top of a total 300,000 increase by Kuwait, UAE and Nigeria (this one looks more doubtful). Over the next few months, Brent is expected to remain in the 110-120$/b range.

The latest data confirm that the economy is gaining pace in Europe. However, real economic data in peripheral countries were less upbeat than what confidence indicators have shown for the two first months of the year. In the US, trade balance and retail sales figures point to strong domestic demand. Meanwhile, the economic activity in emerging countries continues to surprise on the upside, as central banks hike rates to fight inflation. The Central Banks of Peru, Korea, Thailand and Vietnam hiked their policy rates 25bps.

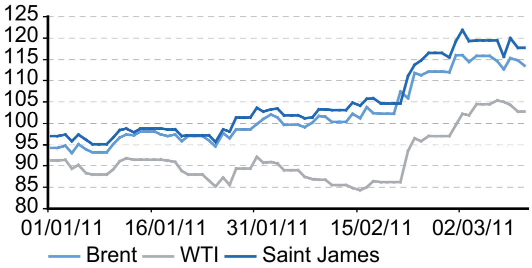
Next week. The US FOMC meeting will catch most of the attention, together with CPI and Industrial production reports for February. In the Eurozone the focus will be on the ECOFIN meeting on Monday and Tuesday and the CPI for February. China will release FDI figures as well as new Yuan loans and money supply.

Chart 1
Sovereign Spreads: 10yr Bond (bps



source: Datastream and BBVA Research

Chart 2
Middle East Unrest Pressure on Oil Prices



Source: Bloomberg

Highlights

A more balanced outlook ahead of the FOMC meeting…

…although we don't expect major changes to the statement.

China's February data surprises to the upside

We expect two more rate hikes, with the next one possibly in the coming weeks.

Income transfers between regions due to spike in oil prices

The MENA region, Latam and Russia are the most favoured.

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Markets

Resistant upper limit on range for Euro and US rates, due to the safe-haven effect

The general context still favours a continued trend of strong upper limits on rates. At the short end of the euro curve levels have been confirmed, following the upward adjustment seen last week in reaction to the "surprise" from the ECB. In any case, no reasons for further rises seem to have been found (the still "hawkish" rhetoric from some ECB board members do not appear to have had an additional impact). This upper limit (at around 2.30% in the 2Y Swap) may also be a reflection of something of a knock-on effect, given the continued firmer upper limits on long-term rates. The long end of the curve is mainly driven by: i) geopolitical risks and the resulting systemic premium which is still being applied; 2) the ratings downgrades of some peripheral countries (Greece and Spain) have merely amplified the save-haven effect on core Govt rates, and this is even transferring to Swap rates. In all, the resistance at around 3.55% remains particularly firm for the 10Y Swap (3.35% for the 10Y German Govt).

In the US this favourable context for bonds is also reflected at the short end of the curve, since in this case there is no hawkish central bank effect to offset it: the dynamic demand in this week's auctions (3Y and 10Y) is a manifestation of this.

USD Decline Takes a Breather

A pause from the recent pace of USD depreciation does not surprise and from a fundamental and flow point of view, lower oil prices and a market that remains short of USD's across the board have helped the USD in the interim. Oil price appreciation ceased over the past week with Brent prices little net-changed around $114 a barrel. Given that the recent trend has been oil stronger / USD weaker, the pause in higher oil prices has had a positive effect on the USD. From a flow perspective, the CFTC's Commitment of Trader's Report released 4 March, 2011 for data up to 1 March, 2011 suggested a record non-commercial net-short USD position versus the major currencies. Key drivers for FX markets remain the MENA situation / oil prices, resolution to the peripheral Eurozone debt situation, extreme USD market positioning and the market's pricing in of additional rate hikes in Europe.

Newsflow concerning peripheral countries continued to dominate credit markets

The week has been marked by Moody's downgrade of the Kingdom of Spain's rating to Aa2 with a negative outlook and publication of the Spanish financial system's capital requirements by the Bank of Spain.

Moody's decision to lower the Kingdom of Spain's rating one notch, which aligns it with S&P, was expected. Nonetheless, the negative outlook was something of a surprise, since the agency has justified its decision based on estimated capital requirements.

In fact, publication by the Bank of Spain of the final core capital data for domestic financial entities and the capital requirements linked to the levels set in Royal Decree 2/2011 brought with it few surprises. In the case of core capital data, there was little variation from the figures released by banks and savings banks in FY10. The announced EUR15.5bn capital requirements are still perfectly manageable for an economy the size of Spain's.

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Highlights

A more balanced outlook ahead of the FOMC meeting

On March 15, the FOMC will meet for the second time in 2011. Members will review recent developments mainly reflecting positive trends in the labour markets. In February, total private non-farm payrolls increased 222K, the second highest gain since March 2006. In addition, the unemployment rate continued to decline to 8.9%, 0.8 pp lower than 12 months earlier. These trends suggest that the recovery is gaining momentum. However, states and local governments continue to implement spending cuts which result in public sector layoffs. In addition, recent spikes in oil prices also add downward pressure on GDP growth. Thus, compared to January's meeting, Fed officials are likely to perceive a more balanced outlook. Meanwhile, although the pass-through from commodity prices to core inflation has been low, some officials are more concerned about potential mid-term inflationary pressures. Overall, we don't expect major changes to the statement.

China's February data surprises to the upside

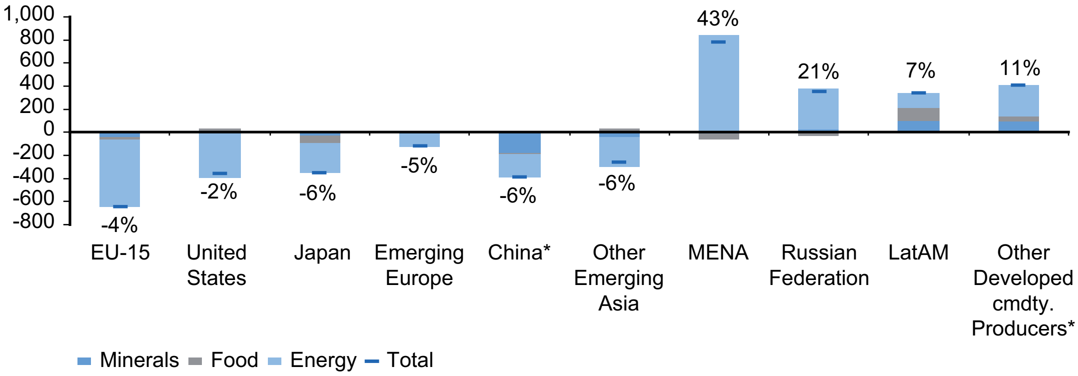
A monthly batch of China economic activity indicators for February was released this week. Headline inflation came in at 4.9% y/y, slightly higher than expected (BBVA: 4.6% y/y; consensus: 4.8% y/y). Other activity indicators, including industrial production and fixed asset investment were stronger than expected. Surprisingly, the trade balance turned to deficit, in weaker than expected exports, although this is likely to be temporary. Importantly, the data for February are difficult to interpret given strong seasonality effects from the Chinese New Year. Combining the January and February data provides a clearer picture: it shows that growth momentum is robust. We maintain our projection of two more rate hikes, with the next one possibly in the coming weeks.

Income transfers between regions due to spike in oil prices

The growing uncertainty surrounding how deep the ongoing civil unrest in the MENA region will be and how long it will last (and its implications in terms of oil supply), suggests that energy prices, and particularly oil, could continue to trend significantly upward in the near term. One of the direct effects of this new scenario would be a bolstering of the income transfers from importing countries (most of the developed economies and virtually all European and Asian emerging countries) to the exporting ones (MENA countries, Latin America and Russia, plus a few African and developed producers). For 2011, considering an oil price benchmark of USD113 /bbl (12 month futures for Brent oil), we estimate the overall commodity transfers would hover around USD2.2 trillion US$[1]. As the following chart shows, the biggest contributors would be the G-3 countries, with more than 60% share of overall transfers, followed by China (18%) and other Emerging Asia (12%). On the other side, the MENA region would receive the biggest part of the cake, with a 38% share, followed by Russia (17%) and Latin America (16%).

Chart 3

Estimated income transfer from commodities net importing countries to producers under a 30% oil price shock with respect to a baseline scenario of USD100/bbl. Accumulated 2011 billion USD and % over GDP



* Other developed producers include Canada, Australia, Norway and Denmark. Emerging Europe includes Turkey. China includes Hong Kong.
Source: World Bank, IMF, Haver and BBVA Research

1: Estimates are based on export and import quantities implied by the latest WDI trade data (2009) for fuels, food and minerals. The benchmark prices assumed for each commodity subgroup are: Brent oil (USD113/bbl); CBOT soya (USD13/ bushel) and CBOT copper (USD8,495/tonne).

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Calendar: Indicators

Eurozone: Industrial production (January, March14th)

Forecast: 0.5% m/m	**Consensus:** 0.4% m/m	**Previous:** -0.1% m/m

Comment: Based on released national figures, industrial output excluding the construction sector is likely to increase by 0.5% m/m in January, after being virtually stable in the previous month. Soft data suggest that the industrial recovery has remained on track at the beginning of the year, supported by external demand. Overall, both soft and hard data point to a rebound in economic activity for Q1. **Market Impact:** After the release of national data, large surprises are ruled out. A negative figure in the still limited hard data available for the current quarter could increase concerns about regained momentum at the beginning of the year.

Eurozone: HICP inflation (February, March 16th)

Forecast: 2.4% y/y	**Consensus:** 2.4% y/y	**Previous:** 2.3% y/y

Comment: We expect headline inflation to be confirmed at 2.4% y/y in February, after 2.3% y/y in the previous month. Our forecast suggests that underlying this inflation increase should be higher energy prices, as in recent months. Furthermore, we expect a slight acceleration in core inflation due to services and processed food components, but remaining at low levels (around 1.2% y/y). Recent oil prices continue to be the main upward risk to headline inflation, with no signs of second round effects yet. **Market impact:** Higher than expected core inflation could impact markets adversely, as any resulting concerns about second-round effects could be read as a trigger for tighter ECB monetary policy.

US: Consumer Prices, Core (February, March 17th)

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

Comment: In January headline and core consumer prices increased by 0.4% and 0.2%, respectively on a seasonally-adjusted basis. Similar to previous months, the main drivers of the increase in headline consumer prices were energy, commodities and food prices which accounted for more than two thirds of the total price increase. The indices for shelter, rent, and owners' equivalent rent continued to increase. Housing price index which accounts for more than 40% of headline CPI increased for the first time on a YoY basis after declining 18 consecutive months. In February, commodity, energy and food prices continued to increase pass-through from headline to core prices is expected to be limited. Therefore, we expect consumer prices to increase significantly at a rate similar to previous month. **Market impact:** Any significant jump in core prices would start discussions of pass-through effect, and might signal inflationary pressures and increase inflation premiums in fixed-income markets.

US: Industrial Production (February, March 17th)

Forecast: 0.7% m/m	**Consensus:** 0.6% m/m	**Previous:** -0.1% m/m

Comment: Industrial production declined 0.1% in January and surprised the markets on the downside. Recent trends support or view that industrial production will jump significantly in February. In the previous month, while material prices dropped 0.3%, final products climbed 1.1% on a MoM basis. Despite economic recovery since mid-2009, capacity utilization remains far away from full capacity. Total capacity utilization was 76.1% in January, mainly due to excess capacity in the manufacturing industry. We expect total capacity utilization to reach 76.4% in February. **Market impact:** A drop in industrial production would indicate a slowdown in economic recovery in 1Q11 and bring down stock markets.

India: WPI inflation (February, March 14th)

Forecast: 8.3% y/y	**Consensus:** 7.8% y/y	**Previous:** 8.2% y/y

Comment: We expect inflation in February to have risen slightly on further double-digit increases in food prices, which remain the biggest contributor to India's inflation. The recent surge in international oil prices is also adding to inflation pressures. The authorities are seeking to contain inflation to 7.0% by end March, still above their 5-6% comfort zone. To achieve this, the RBI hiked policy rates in January by 25 bps, the seventh such increase since March 2010. **Market impact:** A higher-than-expected inflation reading would raise expectations of further monetary tightening. We expect the RBI to hike policy rates again, by 25 bps, at its next policy review meeting on March 17.

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				Close	Weekly change	Monthly change	Annual change
Interest Rates	(changes in bps)	US	3-month Libor rate	0.31	0	0	5
			2-yr yield	0.63	-5	-16	-31
			10-yr yield	3.37	-12	-27	-33
		EMU	3-month Euribor rate	1.18	1	9	53
			2-yr yield	1.67	-10	21	62
			10-yr yield	3.22	-6	-9	5
Exchange Rates	(changes in %)	Europe	Dollar-Euro	1.383	-1.1	0.9	0.5
			Pound-Euro	0.86	0.2	1.2	-5.0
			Swiss Franc-Euro	1.29	-0.3	-1.8	-11.4
		America	Argentina (peso-dollar)	4.03	0.0	0.4	4.4
			Brazil (real-dollar)	1.66	1.1	0.0	-5.8
			Colombia (peso-dollar)	1872	-1.2	-0.9	-1.4
			Chile (peso-dollar)	482	1.7	1.1	-6.8
			Mexico (peso-dollar)	11.97	-0.3	-0.7	-4.6
			Peru (Nuevo sol-dollar)	2.77	0.0	0.0	-2.5
		Asia	Japan (Yen-Dollar)	82.81	0.6	0.5	-8.4
			Korea (KRW-Dollar)	1123.90	0.5	1.4	-0.2
			Australia (AUD-Dollar)	1.001	-1.0	-1.0	9.3
Comm.	(chg %)		Brent oil ($/b)	114.4	-1.4	12.3	44.1
			Gold ($/ounce)	1416.5	-1.0	3.9	28.6
			Base metals	616.5	-1.4	0.2	23.2
Stock Markets	(changes in %)	Euro	Ibex 35	10427	-0.7	-4.7	-5.9
			EuroStoxx 50	2891	-2.0	-4.7	-0.3
		America	USA (S&P 500)	1295	-2.0	-2.0	12.6
			Argentina (Merval)	3406	-1.8	-2.8	44.3
			Brazil (Bovespa)	66041	-2.9	2.8	-4.8
			Colombia (IGBC)	14863	-3.4	2.5	25.2
			Chile (IGPA)	20925	-3.0	-1.6	17.4
			Mexico (CPI)	35891	-2.7	-3.0	10.2
			Peru (General Lima)	21625	-4.6	-5.9	50.4
			Venezuela (IBC)	67613	0.0	1.6	18.8
		Asia	Nikkei225	10254	-4.1	-3.4	-4.6
			HSI	23250	-0.7	0.4	9.6
Credit	(changes in bps)	Ind.	Itraxx Main	103	4	7	29
			Itraxx Xover	393	4	-3	-18
		Sovereign risk	CDS Germany	48	1	-5	22
			CDS Portugal	504	22	71	393
			CDS Spain	257	20	21	162
			CDS USA	44	0	-2	---
			CDS Emerging	215	2	2	-2
			CDS Argentina	619	9	20	-387
			CDS Brazil	115	0	-4	-2
			CDS Colombia	115	0	-5	-23
			CDS Chile	68	-5	-10	-8
			CDS Mexico	109	0	-10	2
			CDS Peru	116	5	1	-1

Source: Bloomberg and Datastream

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