Weekly Watch
Global

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Economic Analysis

Financial Scenarios
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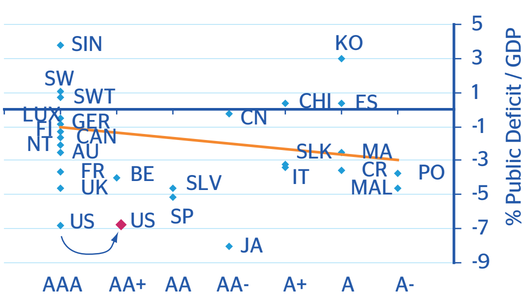
Monetary policy entering a new phase

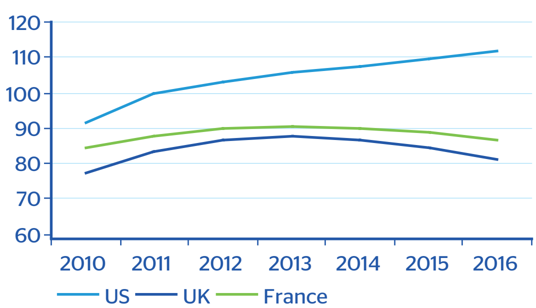
The recent spike in risk aversion reflects a crisis of confidence triggered by mounting fears of a global economic downturn together with ongoing EZ debt woes. The lack of confidence is driven by: a) doubts concerning the room to fight downside risks to growth and avoid another recession in a context of a recovery that has yet to prove self-sustainable, and b) a deepening distrust in policymakers' ability to stop spreading contagion in EZ debt markets and avoid a situation that threatens to become systemic. As a solution to these factors seems much more challenging by the day, while economic agents remain to be convinced that policymakers are taking the appropriate steps to address the problems faced, risk aversion will most likely continue in the near term. The good news is that the deteriorating outlook has not gone unnoticed by central banks and is leading them to reassess the future path of monetary policy. In the case of most central banks in developed countries (so far in the US, UK, Norway, Australia) the message sent is clear: a) exceptionally low interest rates will stay in place for a very long time, longer than previously thought, and b) there is now an easing bias i.e. further stimulus might be implemented if recession risks increase further. The Fed is the most explicit: the FOMC's statement contained a conditional commitment to keeping rates on hold "at least through mid-2013" and a (more explicit than expected) easing bias. Is the ECB next? We think that under a worsening outlook – second-round risks to inflation will be even smaller – the ECB should stop hiking rates. Up until now, the ECB has already amplified the liquidity provision (as Eur Libor-OIS spreads have spiked showing signs of stress and counterparty risk) and reactivated the bond-purchasing program frozen since March (so far effective in containing Italian and Spanish spreads). Meanwhile central banks in emerging markets are shifting their focus from inflation to downside risks to growth; some are deciding to take a pause in rate hikes (e.g. Bank of Korea), others such as Banxico have turned more dovish, and it can be argued that China's PBoC tweaked its wording to a less hawkish tone (confirming on August 9 the objective of taming inflation but dropping the phrase "top priority").

Chart 1
Public deficit to GDP (6-year ahead average)



Source: BBVA Research, Bloomberg and WEO

Chart 2
Debt dynamics: gross debt to GDP



Source: BBVA Research and WEO

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Highlights

Will other AAA-rated countries lose their rating in the near term? It is unlikely

Since the US lost its AAA rating from S&P, investors have turned to other AAA-rated countries that may lose their maximum rating. At first glance the UK and France also seem misaligned compared to other AAA-rated countries (see chart 1). According to the WEO database, the UK and France's fundamental ratios such as public deficit, current account balance and gross debt are above average for AAA-rated countries, but on average 6y ahead their ratios seem to fulfil their fiscal consolidation targets. Moreover, both of them are on a more sustainable fiscal path (see chart 2) and have not showed signs of a dysfunctional political system (as appeared to be the case in the US judging by recent events). Between these two countries, the risk on France's rating is a bit higher if in an adverse scenario (still unlikely) its contribution (guarantees) to the EFSF were to increase, potentially affecting its debt sustainability. In the case of the UK, the British pound's free-float exchange will help boost growth.

Economic Analysis

Global Interest Rates
Interest Rates Europe and USA
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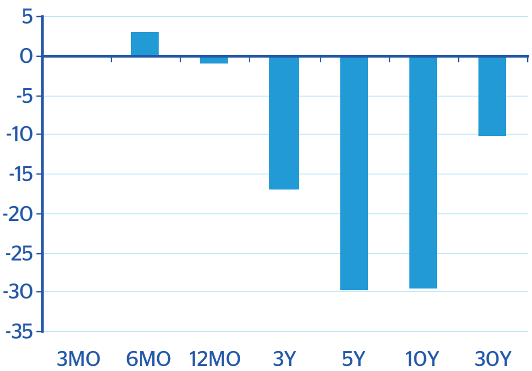
Markets

Three events have been decisive for global markets this week

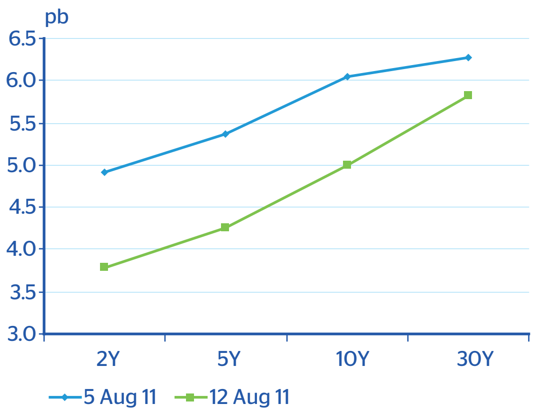
S&P announced the downgrade of the US's long-term rating to AA+ while maintaining a negative outlook. Although it is an unprecedented measure, markets were already giving some likelihood to the event. This fact, together with the current global growth woes and the peripheral crisis, should limit the effect of S&P's decision in the short term. In terms of flows it is important take into account that the response from the international community was not long in coming, saying they still see Treasuries as a safe-haven. Regarding long-term dynamics, we do not expect a long-term effect greater than 50bp. The Fed will hold interest rates at current levels until mid-2013 in response to considerably slower economic growth. This decision should anchor current yield levels (Fed funds futures curve flattened significantly with rates at around 0.10% until the February 2013 future), both in nominal and real terms, at the short-end of the curve. Corrections are likely for longer maturities although an improvement in global risk aversion will be needed. Finally, The ECB announced that it would buy Spanish and Italian bonds under the SMP program. Since then, the countries' 10Y bonds have corrected by 100bp in terms of level and spread with Germany. What is surprising is that it appears that this tightening is due almost exclusively to ECB purchases rather than to those of other participants who are unwinding their positions. This is reflected in the fact that this performance is not uniform throughout the curve, but is concentrated only on the maturities the ECB seems to be buying (5Y-10Y). In this regard, the 10Y/30Y slope, both in Italy and Spain, has gone from 20bp on Monday to 90bp, while inflation breakevens on the Italian 10Y curve have tightened from 190bp to 120bp, a level quite distinct from that seen in other curves such as the French or German curves.

Chart 3
US Treasury yield (change since the day of US downgrade)



Source: Bloomberg

Chart 4
Spanish Gov. bond yield curve



Source: Bloomberg

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Calendar: Indicators

Eurozone: GDP (2Q11, August 16th)

Forecast: 0.4% q/q	Consensus: 0.3% q/q	Previous: 0.8% q/q

Comment: economic activity decelerated during Q2, as expected three months ago. In fact, both confidence data and hard indicators for the current quarter have confirmed this slowdown. In particular, hard indicators were gloomier than expected. PMI's fell sharply in June as well as industrial production and orders have confirmed the slower pace of activity in Q2, partly explained by lower demand from abroad. Eurozone exports increased in May, against expectations, but the slowing trend continues. In addition, trade data suggest that net exports could contribute marginally to GDP growth in Q2. Regarding households' spending, retail sales declined in May, offsetting the gain observed in April, and showing that private consumption could have moderated in Q2. Overall, these signs were widespread across member states, while consumers' confidence also supported this view. Overall, the short-term model for the eurozone points to growth at 0.4% q/q in Q2 (with downward risks after the bad data posted in France for Q2 and worse than expected industrial production in the eurozone for June published on Friday). This is in line with our baseline scenario of slower growth for the rest of the year, after a strong Q1 due to temporary factors. Uncertainty has increased, however, linked to possible faster deceleration of global demand than anticipated as well as to the still unresolved sovereign debt crisis. In addition, there is further evidence of a multi-speed recovery, mainly determined by the evolution of domestic demand, which is lagging behind significantly in peripheral countries, as fiscal consolidation efforts intensify and de-leveraging continues. **Market impact:** a worse than expected growth rate would add uncertainty to the eurozone macro outlook and confirm a faster moderation in economic growth than anticipated.

US: Industrial Production (July, August 18th)

Forecast: 0.1%	Consensus: 0.4%	Previous: 0.2%

Comment: slow economic activity and weak demand expectations point to low m/m industrial production growth in July. Industrial production stalled after an uptick in March, declining in two of the three reports since. The decline is consistent with the recent GDP release of below-average growth for 2Q11 which is also expected to continue throughout 2H11. Exports, which buoyed 1H11 domestic manufacturing, also declined in May and June. Furthermore, auto sales reports and manufacturing surveys in July showed a large drop in auto production as well as reduced manufacturer expectations, further eroding any optimistic notions. **Market Impact:** A weak Industrial Production report will increase the downside risk for the 2H11 GDP. If the report is suggestive of a recession, it is likely that markets will become more defensive

US: Consumer Price Index, Core (July, August 19th)

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

Comment: after a torrent start to 2011, headline consumer prices declined 0.2% in June. Headline consumer price inflation is expected to be minimal in July given that energy price increases have slowed and other major contributors to inflation are likely to remain stable due to weak economic activity. Furthermore, low consumer demand should offset any increases in commodity prices, limiting runaway food inflation. In addition, the housing price index, a large contributor to core prices, has been increasing but remained relatively stable throughout 2011, indicating that there is limited upside risk to core prices in July. **Market Impact:** with the economy in neutral and energy prices dropping, markets might begin to worry about deflation. Conversely, another big jump in core consumer prices could be a sign of inflationary risks and complicate the Fed's ability to keep rates historically low for an extended period.

Japan: GDP growth (2Q11, August 15th)

Forecast: -0.7% q/q s.a	Consensus: -0.7% q/q s.a.	Previous: -0.9% q/q s.a.

Comment: 2Q11 GDP data will reflect the full-quarter economic impact of the March 11 earthquake. First quarter GDP was weaker than expected, but this mainly reflected sluggish activity prior to the quake. Most activity indicators point to a steep decline in production and exports in March/April, with a rebound beginning in May as supply chain disruptions eased. As a result, Q2 GDP growth is expected to have contracted for a third consecutive quarter, although we expect a rebound in the second half year. **Market impact:** A slower-than-expected reading, especially beyond that which can be explained by disruptions from the earthquake, could intensify concerns of global weakness and could dampen sentiment.

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			Close	Weekly change	Monthly change	Annual change
Interest Rates (changes in bps)	US	3-month Libor rate	0.29	2	4	-8
		2-yr yield	0.19	-10	-16	-34
		10-yr yield	2.25	-31	-63	-42
	EMU	3-month Euribor rate	1.54	-3	-7	64
		2-yr yield	0.70	-7	-58	4
		10-yr yield	2.34	0	-40	-5
Exchange Rates (changes in %)	Europe	Dollar-Euro	1.424	-0.1	0.6	11.3
		Pound-Euro	0.87	0.5	-0.4	6.7
		Swiss Franc-Euro	1.10	0.6	-5.3	-18.3
	America	Argentina (peso-dollar)	4.16	0.1	0.9	5.7
		Brazil (real-dollar)	1.62	1.7	2.8	-8.8
		Colombia (peso-dollar)	1783	-0.7	1.4	-2.7
		Chile (peso-dollar)	471	1.3	1.8	-7.6
		Mexico (peso-dollar)	12.29	2.7	5.1	-3.3
		Peru (Nuevo sol-dollar)	2.74	0.2	0.1	-2.2
	Asia	Japan (Yen-Dollar)	76.68	-2.3	-2.9	-11.0
		Korea (KRW-Dollar)	1080.33	1.8	2.3	-9.2
		Australia (AUD-Dollar)	1.031	-1.7	-4.3	15.0
Comm. (chg %)		Brent oil ($/b)	108.3	-1.0	-8.8	44.2
		Gold ($/ounce)	1736.6	4.4	9.7	42.9
		Base metals	564.9	-2.9	-5.2	13.5
Stock Markets (changes in %)	Euro	Ibex 35	8562	-1.3	-11.4	-16.7
		EuroStoxx 50	2299	-3.2	-15.3	-15.1
	America	USA (S&P 500)	1173	-2.2	-11.0	8.7
		Argentina (Merval)	2949	-3.9	-12.1	24.5
		Brazil (Bovespa)	52682	-0.5	-13.2	-20.5
		Colombia (IGBC)	13262	0.1	-0.6	-0.3
		Chile (IGPA)	20302	3.9	-9.4	-2.6
		Mexico (CPI)	33811	0.3	-6.7	5.3
		Peru (General Lima)	19755	-2.0	-2.3	33.5
		Venezuela (IBC)	96415	3.7	17.8	48.9
	Asia	Nikkei225	8964	-3.6	-10.0	-3.1
		HSI	19620	-6.3	-10.5	-6.9
Credit (changes in bps)	Ind.	Itraxx Main	156	19	38	43
		Itraxx Xover	654	103	213	141
	Sovereign risk	CDS Germany	87	13	31	43
		CDS Portugal	876	-43	-198	601
		CDS Spain	369	-36	50	151
		CDS USA	52	-3	1	---
		CDS Emerging	294	45	73	65
		CDS Argentina	793	113	164	-40
		CDS Brazil	161	30	45	41
		CDS Colombia	160	33	48	38
		CDS Chile	106	28	30	26
		CDS Mexico	161	33	47	43
		CDS Peru	171	28	44	61

Source: Bloomberg and Datastream

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