

# Weekly Watch

## Global

Madrid, 13 May 2011

### Economic Analysis

Financial Scenarios

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## Sovereign risk in the spotlight

European Sovereign risk is once again back on the centre stage. Under the assumptions of the IMF and EU aid package, Greece will not fund its financial gap if it cannot access financial markets in 2012. This news induced fears of an imminent Greek debt restructuring, which we think is unlikely in the short-term (see highlight). Furthermore, Standard and Poor's downgraded Greece's long and short-term debt to B and C, respectively, on the view that Eurozone official creditors may extend the debt payment maturities of their bilateral loans. Additionally, there has been a lot of noise in recent days about the Finnish and German Parliaments' support of Portugal's bail-out package, which is expected to be endorsed in the ECOFIN meeting on Tuesday. All in all, it seems that European sovereign news flows will be challenging for the European risk premium. We also expect the Greek aid package to be discussed at the ECOFIN meeting, although we do not anticipate any agreement until the European Council meeting on 24 June. Thus, until then the market will closely watch any political and economic developments in Greece. Strong government and fiscal discipline measures are the best presentation cards for an additional aid package.

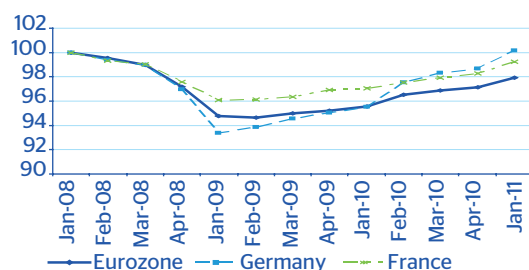
### Strong growth rate in 1Q11, but this looks set to ease

The EZ 1Q11 GDP growth rose 0.8 q/q, above our expectations of 0.6 q/q. Germany and France both registered healthy growth driven by stronger domestic demand, while the former has recovered its pre-crisis GDP levels. Meanwhile, US activity and inflation showed the effects of higher oil prices. In Emerging markets, China's April data showed that the country's growth is still slowing, as monetary conditions continue to tighten. Inflation measures have moderated since March, but were slightly above expectations. We expect the Chinese authorities to sustain their gradual monetary tightening to tame inflation, with two more 25bp interest rate hikes in 2Q/3Q and an additional 100bp of hikes in the required reserve ratio, (RRR) after yesterday's 50bp hike in RRR. In Latam, activity remains upbeat, while growth in Mexico is easing slightly. Latam central banks continue to fight overheating by increasing rates and introducing macro-prudential measures. Chile and Peru increased interest rates this week.

**Next week:** The EZ final April CPI -which will likely confirm the 2.8% increase-, will be released. This figure will be very closely watched, especially after the latest Survey of Professional Forecasters revised the 2011 and 2012 inflation projections up by 0.6pp and 0.1pp, to 2.5% and 1.9%, respectively, although long-term inflation expectations remain anchored at 1.9%. Overall, the latest data and recent statements by ECB members are in line with our expectation that the June meeting will see wording changes which will signal a 25bp interest rate increase at the July policy meeting. In the US, the market will look for further hints of the phasing-out process after the end of the QE2 in the minutes from the last FOMC.

Chart 1

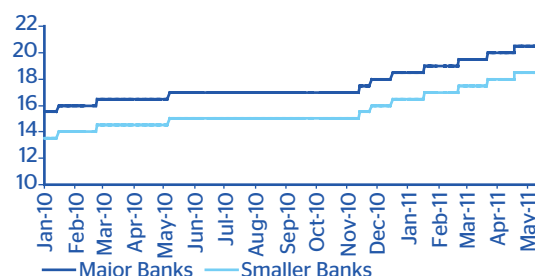
GDP (Index, T1 2008=100)



Source: Eurostat and BBVA Research

Chart 2

China: Reserve Requirement ratio (RRR)



Source: Bloomberg and BBVA Research

Markets



Highlights



Calendar



Markets Data



## Highlights

### Strong global economy growth, but risks are tilted to the downside

Global growth is expected to expand 4.4% both in 2011 and 2012.

### Financing Greece

Extending the financial support will provide a short-term solution for Greece's solvency problems.

### Higher, but still low core inflation in the US

All core inflation measures indicate a recent upturn in inflation, but from extremely low levels.

## Markets Analysis

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## Markets

## Short-term rise in equity risk premium

The slight drops seen in equity markets in recent days, pricing in slightly lower than previously expected growth rates for 2011, have occurred against a backdrop of sharp drops in the long ends of interest rate curves. Taking into account the resilience of the current consensus estimates for EPS, particularly following the 1Q earnings seasons, which beat the consensus in revenues and profits, what is happening, at least in the short term, is a clear increase in risk aversion on equity markets.

There are two reasons for this: on one hand, the latest macro data for the US, Europe and Asia is allowing equity markets to price in a scenario of lower than expected growth rates in 2011; on the other hand, we have the rise in sovereign risk linked to this worse cyclical outlook (sovereign risk mirrors cyclical risk) and the rumours surrounding Greece.

## Volatility of oil affecting the rate curve

The recent volatility of commodities, and especially oil, is a result of the following factors: firstly, adjustments are being made to the overly long positions accumulated in the last few months due to the sharp rise in prices. Secondly, the recent performance of some equity markets has increased the margins required, forcing many market participants to cut their positions short, generating a lot of volatility. These fluctuations in oil prices are having a direct impact on rate curves, and especially inflation breakevens. These breakevens are a measure of the market's headline inflation expectations for the coming years, and are calculated as the difference between the nominal rate and the real rate. The impact from oil is therefore twofold: on one hand it directly affects the market's long-term expectations for inflation, and on the other it has a direct effect on real rates, since they are linked to growth. In short, cheap oil improves expected growth so real rates rise, while climbing oil prices have the opposite effect.

## Risk aversion favours buying of USD

As a result of the increase in the global risk premium, the market's main driver is risk aversion, taking the spotlight off other drivers such as the contrasting expectations with regard to rate hikes from the ECB and the Fed, fundamentally resulting from the rise in inflation and expected growth. This favours widespread buying of USD, magnified by extremely short net USD positioning. In the case of EURUSD, on top of the profit taking on commodities (triggered by the CME's increased guarantee requirements and the rise in the Chinese CPI, reflecting a need for stricter monetary policy from the PBoC) there has been less hawkish rhetoric from Trichet at the last ECB meeting on 5 May - by omitting the words "strong vigilance" he indicated that there would be no rate hikes before June - and growing concern over European peripheral debt, particularly Greece's.

Chart 3

**Oil prices and US 10Y inflation breakeven**



Source: Bloomberg and BBVA Research

Home



Highlights



Calendar



Markets Data



## Economic Analysis

## Highlights

## Economic Scenarios

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## Strong global economy growth, but risks are tilted to the downside

The global economy continues to grow at a robust pace, and is still expected to expand 4.4% both in 2011 and 2012, supported primarily by emerging economies, which will account for ¾ of the increase. However, higher commodity prices (especially oil) introduce a risk to growth (even to some of those that might benefit directly from high commodity export prices) will push up inflation in most regions, bringing forward interest rate hikes from most central banks, though at different paces. At the same time as this global shock develops, local risks remain in place. Financial stress in Europe is likely to continue, especially for Greece, Portugal and Ireland. The political noise around proposals to finally start the process of fiscal consolidation in the US will only add to uncertainty in the markets, even though we think that some form of fiscal adjustment will take place in the end. Finally, overheating pressures in emerging markets continue, although they will probably increase more in Latam than Asia, given that high commodity prices represent tailwinds for Latam but headwinds for Asia. In addition, the slowdown in Japan could slow down economic activity in most of Asia. Furthermore, current account surpluses in much of Asia are a more comfortable buffer for countries in the region compared to Latam (see [Global Outlook](#)).

## Financing Greece

The IMF+EU aid package to Greece was designed under the assumption that Greece could access financial markets in order to fund part of its financial needs after 1Q12. This assumption is now very unlikely to be met under the current market conditions, and therefore Greece must find other ways of financing its needs. The government has already announced a privatisation process to raise EUR50bn of new revenues until 2015, but this will not arrive in time. In our view, the most likely solution in the short term is that the IMF&EU will extend their financial support to Greece with strict conditions. We expect the maturity of the IMF&EU loan to be extended to 7 ½ years from the current 4 years (already proposed and only in need of ratification), and the loan's interest rate to be lowered by 100bp to 4% (perhaps gradually and subject to fiscal consolidation targets being achieved). Furthermore, an additional aid package of around EUR50-90 will be needed to cover the long-term debt maturities until mid-2013 or 2014, respectively. Although EU ministries will probably debate the Greek aid package at next week's ECOFIN meeting, we do not anticipate any official announcement until the EU Council meeting in June, and more likely not until the IMF, EU and ECB analysis of the Greek aid programme review, which should be ready by mid-June, have been carefully looked at.

## Higher, but still low core inflation in the US

In April, headline and consumer prices jumped 0.4% m/m and 0.2% m/m, respectively. Consumer prices increased 3.2% y/y, the highest level since October 2008. In November, the inflation rate was 1.1% y/y, this sharp increase was due to the combination of high liquidity and rising food and energy prices. However, the pass-through effect to underlying inflation remains limited. While energy and food indices increased 19.0% and 3.2% y/y respectively, core prices (all items less food and energy) increased only 1.3% in the same period. We expect the increase in energy prices to be temporary and the pass-through effect to remain limited. In retrospect, in similar episodes the impact on core inflation remained minimal for the U.S. economy and declined significantly relative to the 1970s and 1980s. On the other hand, all core inflation measures indicate a recent upturn in inflation, but from extremely low levels. Shelter prices comprise 40% of the core inflation and have a strong effect on the future path of trend inflation. This boils down to rent and owner's equivalent rent, both of which are affected by home prices. Owner's equivalent rent is increasing on a y/y basis, although from low levels. Providing that home prices stabilize and commodity prices decline in 2H11, we expect these three components of inflation to make a smaller contribution to core inflation by 2012. We expect average headline and core inflation rates in 2011 to increase to 2.8% and 1.3% y/y, respectively.

Home



Markets



Calendar

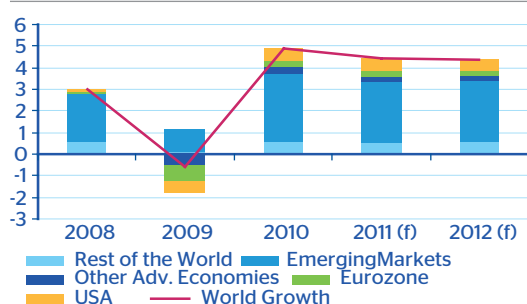


Markets Data



Chart 4

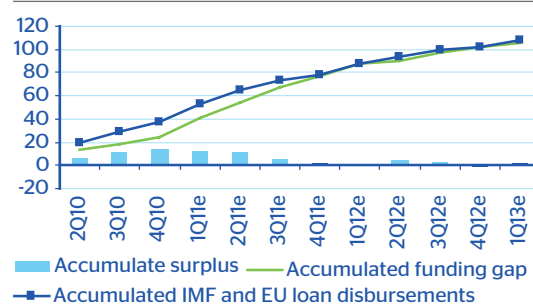
## Global GDP growth and contributions (%)



Source: BBVA Research and IMF

Chart 5

## Greek government's financial position\*



\* Considering Greece access financial markets in 2012  
Source: BBVA Research and IMF

## Economic Analysis

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## Calendar: Indicators

## Eurozone: HICP inflation (April, May 16th)

Forecast: 2.8% y/y

Consensus: 2.8% y/y

Previous: 2.7% y/y

**Comment:** We expect final HICP data to confirm that consumer inflation accelerated by 0.1pp in April, against our initial expectations of stabilization. Advanced inflation with recent fuel prices suggests that the slight increase could be explained by a further acceleration in inflation of both food and some components of core inflation. In particular, we can not rule out a slightly larger than previously anticipated acceleration in service inflation, due to the base effect after the sharp slowdown observed in April last year, combined with an usual increase in service prices at Easter, as national figures suggested. **Market impact:** A large surprise in core inflation could be interpreted as further evidence of indirect effects from rising commodity prices on higher and more persistent consumer inflation, fueling fears of second-round effects in coming months.

## Eurozone: Trade balance (March, May 16th)

Forecast: €-3.2bn

Consensus: n.a.

Previous: €-2.4bn

**Comment:** The trade deficit is likely to have broadened further in March. Exports are expected to have grown moderately, at similar rates to February, after the strong rebound observed at the beginning of the year, supported by resilient demand from emerging markets. As a result, exports should have gained momentum in Q1 as a whole. Nevertheless, imports are projected to have grown at a faster pace in March, driven mainly by higher commodity prices, after the sharp slowdown registered in the previous months. In addition, imports should have also surged in Q1, suggesting that the contribution from net exports could have been lower than in 2H10. **Market impact:** A very negative surprise could raise concerns about the pace of the recovery in coming quarters, especially in the periphery.

## Empire State Manufacturing Index (May, May 16th)

Forecast: 18.5

Consensus: 20.0

Previous: 21.7

**Comment:** The Empire State Manufacturing Index is expected to decline but remain positive in May, indicating that more manufacturers consider that business conditions are improving. The index is one of the first regional indices to be released this month and will give valuable information about economic activity in the manufacturing sector. We expect economic activity in 2Q11 to be stronger than in the first quarter. **Market impact:** A sharp decline in the index would signal a slow down in manufacturing activity and draw stock markets down.

## Industrial Production (April, May 17th)

Forecast: 0.5% m/m

Consensus: 0.4% m/m

Previous: 0.8% m/m

**Comment:** Industrial production index has increased in the last 21 months, except October 2010. In March, the index jumped 0.8% m/m and was 5.9% higher than its level in the previous year. The manufacturing activity climbed 0.7% m/m and capacity utilization in the sector reached 75.3%, lower than its pre-crisis level. The Utilities sector picked up 1.7% m/m and the utilization rate in the sector increased to 79.7%. Overall, the capacity utilization rate is 77.4%, illustrating that the economic slack still remains in the economy. We expect the industrial production index to increase at a slower pace in April due to high oil prices. **Market impact:** If the index declines in April, it would likely increase doubts over the pace of the recovery and ignite discussions of a recession or a slow down in the economy.

## India: WPI inflation (April, May 16th)

Forecast: 8.2% y/y

Consensus: 8.4% y/y

Previous: 9.0% y/y

**Comment:** Inflation has become the major policy concern across emerging Asia, with India struggling more than most of its peers. In this regard, next week's inflation release for April will be under the spotlight, especially after the RBI surprised markets early this month with an aggressive 50bp rate hike. We expect April inflation to decline from last month due to base effects and moderating food prices, but nevertheless remain elevated. **Market impact:** A higher than expected outturn could raise expectations of an even stronger policy response, while a lower outturn would improve sentiment.

Home



Markets



Highlights



Markets Data



## Markets Data

			Close	Weekly change	Monthly change	Annual change
Interest Rates (changes in bps)	US	3-month Libor rate	0.26	-1	-2	-18
		2-yr yield	0.55	0	-17	-23
		10-yr yield	3.22	7	-24	-23
	EMU	3-month Euribor rate	1.42	0	9	74
		2-yr yield	1.81	5	-5	126
		10-yr yield	3.14	-3	-30	28
Exchange Rates (changes in %)	Europe	Dollar-Euro	1.429	-0.8	-1.1	15.0
		Pound-Euro	0.88	-0.1	-1.2	3.0
		Swiss Franc-Euro	1.26	-0.1	-2.5	-10.0
	America	Argentina (peso-dollar)	4.08	0.0	0.6	4.7
		Brazil (real-dollar)	1.62	0.7	1.7	-10.1
		Colombia (peso-dollar)	1800	1.9	-1.1	-8.8
		Chile (peso-dollar)	467	-0.3	-1.0	-12.6
		Mexico (peso-dollar)	1163	0.1	-1.5	-7.3
		Peru (Nuevo sol-dollar)	2.77	-0.8	-1.6	-2.5
	Asia	Japan (Yen-Dollar)	80.52	0.2	-3.9	-12.6
		Korea (KRW-Dollar)	1086.55	0.7	-0.2	-5.0
		Australia (AUD-Dollar)	1.070	-0.4	1.9	20.4
Comm. (chg %)		Brent oil (\$/b)	114.3	4.7	-7.0	48.1
		Gold (\$/ounce)	1514.3	1.2	3.9	22.8
		Base metals	602.7	-0.1	-5.1	22.9
Stock Markets (changes in %)	Euro	Ibex 35	10497	-1.1	-2.7	12.7
		EuroStoxx 50	2926	-0.9	-0.8	11.1
		USA (S&P 500)	1349	0.6	2.6	18.8
	America	Argentina (Merval)	3390	2.2	-0.5	53.2
		Brazil (Bovespa)	64003	-0.6	-3.7	0.9
		Colombia (IGBC)	14277	3.1	0.1	16.8
		Chile (IGPA)	23013	1.0	4.2	28.1
		Mexico (CPI)	35161	-0.1	-5.9	10.5
		Peru (General Lima)	21484	-1.3	15.4	41.4
		Venezuela (IBC)	77434	0.8	10.0	24.0
	Asia	Nikkei225	9649	-2.1	0.1	-7.8
		HSI	23163	0.0	-4.0	15.0
Credit (changes in bps)	Ind.	Itraxx Main	97	1	0	-12
		Itraxx Xover	358	4	-11	-154
	Sovereign risk	CDS Germany	39	0	-3	-9
		CDS Portugal	627	-8	52	389
		CDS Spain	242	0	20	63
		CDS USA	43	0	1	---
		CDS Emerging	206	-1	8	-45
		CDS Argentina	587	-4	35	-344
		CDS Brazil	103	-1	-4	-28
		CDS Colombia	102	2	2	-56
		CDS Chile	60	0	1	-29
		CDS Mexico	99	-1	-1	-29
		CDS Peru	135	-2	-14	5

Source: Bloomberg and Datastream

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