BBVA Research

Global

Weekly Watch

Madrid, 14 January 2011

Economic Analysis

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Central Banks and inflation

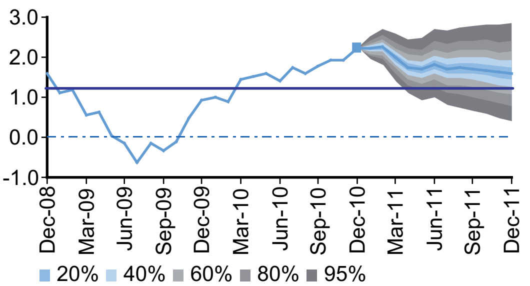
Commodity prices are behind recent inflation spikes, not only in Europe but also in the US and Emerging Economies. In Europe, the ECB echoes this environment and has accommodated its language, more hawkish than expected, and also emphasizes that they see the rise in inflation as transitory. We focus on this scenario, where core inflation remains slightly above 1%. In the US core inflation remains well below Fed's mandate. Meanwhile, in emerging economies with stronger growth, concerns over inflation are increasing, especially in Asia. This has prompted policy responses in Asia. Both Thailand (expected) and Korea (unexpected) hiked interest rates this past week citing inflationary pressures (Asian Weekly). European Sovereign risk had some relief after Spanish and Portuguese bond auctions faced better demand than expected: the bid to cover ratio was 2.9x vs 2.4x previous for Portuguese bonds and 2.1x vs 1.6x previous for the Spanish auction. Also, proposals to reinforce the EFSF ahead of the Ecofin meeting have helped to reduce the risk premium.

Economic data showed recovery in DM and flows pressure on EM

Economic data show a slight acceleration in 4Q in Europe, as Eurozone industrial production in November was stronger than expected. Our economic synthetic indicator estimates that GDP could have grown by around 0.5% q/q, after 0.3% q/q in Q3. Notice also that Germany grew 3.6% y/y in 2010, a strong recovery from the -4.7% in 2009. Eurozone inflation rose to 2.2% y/y in December, with commodity prices explaining most of it. In China credit and M2 growth remained above target, reinforcing expectations of further tightening while excess of foreign reserves put pressure on China to accelerate the pace of currency appreciation. In the US, headline inflation increased to 1.5% y/y in December from 1.3% in the previous month; yet, core inflation remains low (0.8% y/y). The recovery in domestic demand continued in December with both Retail sales and industrial production showing healthy gains. Next week important data will be released. In China, 4Q GDP, December inflation and property prices will be released. In the US focus will be on housing data while in Europe the Ecofin meeting and German IFO will be the most interesting issues.

Chart 1

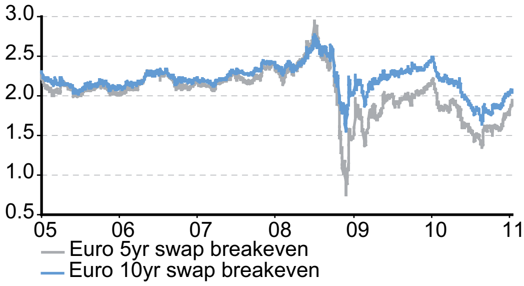
Euro zone: HICP (% y/y)



Source: BBVA Research

Chart 2

Euro inflation-linked swap breakevens



Source: Bloomberg and BBVA Research

Highlights

Next Ecofin meeting

Ecofin could provide some clues on proposals to reinforce the EFSF. But we only expect a return to normality once the outlook for governance is clarified by the end of March.

Portugal

Potential growth is still very low and the current account is too high. Stepping up reforms is required.

Spanish exposure to Portugal

Spain's exposure to Portugal in terms of trade and FDI is limited.

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Markets

Caps on the recent rises in rates and the euro

The performance of assets in the Eurozone has changed drastically in recent days, as a result of two factors: on one hand, and above all, a change in the perception of sovereign and financial risk in the Eurozone. On the other hand, in recent days, more attention has been paid to inflationary risks in the Eurozone, as a result of the increased concern shown by the ECB in its rhetoric. The first of these two factors has been reflected above all by interest rates, in the form a moderation of the safe-haven effect seen in core bonds (the German 10Y Govt has risen by around 25bps, making a return 3.05%). This has been accompanied by an improvement in the valuations of the stocks in the sectors which have been most affected by the situation (Financial), easing credit spreads, narrowing core-periphery spreads, and appreciation in the euro (around 3 figures vs. the dollar and 1% in the Eff. Exc. Rate). This profile (above all in terms of interest rates) has subsequently been accentuated by the second factor: Trichet's references to a context of inflation tending to rise in the short term has pushed rates up, and as a result the euro has been driven up as well. Even taking into account these factors, our outlook for the time being has not changed significantly.

The containment of sovereign risk triggers a cautious rally for the Financial sector

The containment of European sovereign debt problems is soothing the fixed-interest markets, easing the pressure on 10-year spreads against the Bund. The principal beneficiary of this scenario is the banking sector, due to both promises of cheaper funding in future and their direct balance-sheet exposure to sovereign bonds. Based on this, there has been a rapid recovery in the Eurostoxx50 since the December 2010 lows (financials have a weighting of 26%). The European index has thus recovered the technically significant level of 2,850 and has even managed to break through the 2,900 barrier for the first time since May 2010. Nonetheless, all this will depend on a favourable news flow from Brussels. In this regard, our key diary date is 4 February, the meeting of the Heads of State.

Credit markets remain volatile

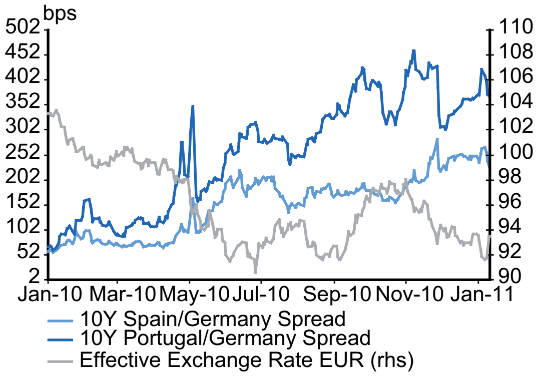
Following the success of the Spanish and Portuguese auctions, and above all following the news that changes may be made to the EFSF, the main synthetic indices narrowed significantly, reversing the widening seen in the previous week. The iTraxx Main and iTtraxx SovX WE have narrowed 12bps and 24 bps respectively so far this week, reaching 104bps and 222bps.

Looking at the financial indices, the Itraxx Fin Senior has narrowed 32bps so far this week, to 178bps. This move reversed the widening seen last week as a result of a working paper released on 6 January by the European Commission, which includes proposals for a European framework to deal with potential future collapses of banks, and which mentioned the possibility of writedowns on senior debt. In our view, the market overreacted to the publication of this report, for three reasons: 1) the text states that the measures would be applied during potential future banking crises, and not now; 2) legislative processes tend to be slow; and 3) the writedown would not be applied to senior debt which has already been issued. Meanwhile, the iTraxx Fin Sub narrowed 60bps to 312bps.

Chart 3
iTraxx Fin Sub / iTraxx Fin Senior Ratio

Source: Bloomberg

Chart 4
Peripheral Spreads vs. EUR Effective Exchange Rate



Source: Bloomberg and BBVA Research

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Highlights

Next Ecofin meeting

In recent days some proposals have been put on the table to reinforce the EFSF, including quantitative measures (more money) or qualitative ones. Both types of measures were discussed prior to the December summit and rejected, but now a flurry of declarations (including Merkel and Barroso and Trichet) suggest that progress goes in that direction. On quantitative measures, the most feasible option would be to allow the EFSF to lend the full 440 bn promised in May, as it is recognized that the actual capacity is much lower (around 240 bn); despite declarations by Schauble in this sense, there is no unanimity in the German government on it and interpreting Merkel's declarations in the sense that this is a done deal would be a stretch, at least for the moment. On qualitative measures, a possible option is to allow the fund to buy bonds in the secondary market (thus relieving the ECB from a task that it fulfils only reluctantly), but also helpful would be to reduce rates paid by countries to the EFSF to more sustainable levels, and this has been mentioned by Commissioner Olli Rehn. We expect decisions for the next summit in early February at the earliest, rather than at next week's Ecofin. However, the lack of a unified view within the German government implies that a final decision might only be taken by end-March, in a whole package that includes a satisfactory solution for a crisis resolution regime and the solvency problems of countries with very high debt ratios. Until those points are successfully addressed, we do not expect a normalization of tensions in the Eurozone.

Portugal

Portugal has been a focus of attention this week, for various reasons. Amidst rumours of imminent rescue, the Treasury managed to sell 2014 and 2020 bonds with sound demand and at lower than expected rates. Previously the Prime Minister had advanced that the public deficit target of 7.3 for 2010 had been largely met (the final figure will be between 6.9 and 7.1%). Although this will be achieved through the transfer of the pensions fund of Portugal Telecom to the State (a measure announced in Autumn, equivalent to 1.5% of GDP), final revenues have also been higher than expected (growing by 5.3% instead of the target of 4.5%). In addition, the Bank of Portugal revised downwards its GDP projections for 2011 to -1.3% on account of the fiscal contraction and scarce credit. This figure is in line with the IMF forecast, but is too negative, in our view. Although the private consumption projection (-2.7%) could materialize, given the rapid fall in confidence, lower wages and higher VAT, the projected fall of 6.8% in investment is too negative, especially considering the expected rise in exports (5.9%). Our GDP projection is of a more moderate fall, of around -0.5%. Having said this, we maintain our view that potential growth is still very low and the current account too high and adjusting only slowly. Both require stepping up structural reforms, starting with the rapid and decisive implementation of the reform package announced in December.

Spanish exposure to Portugal

The exposure of the Spanish economy to Portugal becomes a relevant issue as the Portuguese economy is expected to show negative numbers in 2011 and there is a risk that Portugal might ask for aid from the EU. Portugal is the fourth largest partner of Spain in trade in goods, but it contributes to only 6% of total Spanish foreign trade, which accounts for around 2% of GDP. Therefore, a strong deterioration in their economy would have a negative, though moderate, impact on Spanish economy. Spain is even less exposed to Portugal in terms of trade in services. Only 3.6% of total trade in services is held with Portugal, accounting for 0.5% of GDP. The exporting sectors with the highest exposure to Portugal are manufactured goods. Regarding FDI, Portugal is the seventh investment partner of Spain, holding 5.7% of total outward FDI stock, which accounts for 2.3% of GDP. However, while Portugal was the third recipient of Spanish FDI outflows in the 1993-1999 period, it ranked eighth during the 2000-2009 period, with an important reduction of outward flows in the last years. A deterioration in the Portuguese economy would affect the overall Spanish FDI mainly through the financial intermediation sector, but the largest Spanish banks' exposure to Portugal represents only 1.4% of its total assets. All in all, Spain's exposure to Portugal in terms of trade and FDI is limited.

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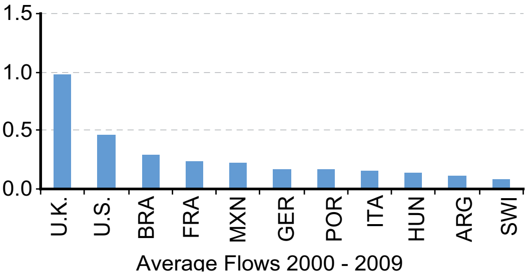
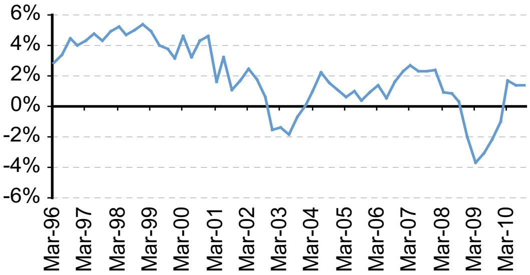
Chart 4
Spain: outwards FDI flows by partner country (%GDP)



*FDI flows excluding FSHC operations
*Excluding The Netherlands and Luxembourg
Source: INE

Chart 5
Portugal GDP growth y/y ch.



Source: INE

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Calendar: Indicators

Germany: Ifo Business Climate (January, January 21st)

Forecast: 109.9	**Consensus:** 109.8	**Previous:** 109.9

Comment: Business confidence is expected to stabilize in January, but remaining close to record high levels. This stabilization would comprise a slight improvement of the current economic situation, although expectations for coming months are expected to decline somewhat, as strong economic momentum is unlikely to linger after having recovered around 80% of the output decline registered during the crisis. **Market Impact:** A sharp decline in business sentiment should be perceived by the markets as a sign of a clear slowdown in economic activity.

Germany: Producer Prices (December, January 20th)

Forecast: 0.2% m/m	**Consensus:** 0.5% m/m	**Previous:** 0.2% m/m

Comment: Producer prices are expected to increase further in December at a rate similar to those observed in the last quarter of 2010, although the 3-month moving average shows that industrial inflation is slowing over the second half of the year. Underlying the increase in industrial inflation could be the rapid gain in the level of the capacity utilization in H1 2010. Even though German domestic demand is strengthening, we think that it is not robust enough to trigger a complete translation of the increase in pipeline inflation to final consumer prices. **Market Impact:** A sharp increase in industrial inflation could be interpreted by markets as higher inflationary pressures in coming months, especially after the more hawkish mode shown by the ECB this week, with headline inflation over 2% (although temporarily).

US: Housing Starts (December, January 19th)

Forecast: 560K	**Consensus:** 552K	**Previous:** 555K

Comment: : Housing starts are expected to recover slightly in December. Housing demand is picking up from the last summer low sales, new home prices are now more stable and inventories of new homes have dropped to extremely low levels. All these factors create a more favourable environment for home builders and we expect housing starts to improve a bit in December. Nevertheless, construction remains at extremely low levels with housing starts more than 60% below historical average. This sector will continue to face challenges as existing homes are more affordable than new homes. As a result, existing home inventories need to decline before we see a strong recovery in housing starts. **Market impact:** Market is not expecting a major change in housing starts. However, any significant rise in housing starts would imply an improvement in residential investment.

US: Initial Claims (Jan-15, January 20th)

Forecast: 430K	**Consensus:** 425K	**Previous:** 445K

Comment: Latest employment surveys show improvements in the labour markets. ADP employment report registered, in December, the largest increase historically since the start of the survey which goes back to 2001. Private nonfarm payrolls, released by BLS, indicated a moderate gain in employment in December. Private (total) nonfarm payrolls rose only by 113K (103K). We expect that labour market conditions will continue to improve as the economic recovery progress. We forecast a small decline in both initial and continuing claims. **Market impact:** Better-than-expected initial data would point to further improvement in labour markets.

China: CPI (December, January 20th)

Forecast: 4.9% y/y	**Consensus:** 4.6% y/y	**Previous:** 5.1% y/y

Comment: China's CPI inflation accelerated to 5.1% in November, prompting the authorities to intensify monetary tightening measures, including both a 25bps interest rate hike and a 50 bps hike in the required reserve ratio (RRR) in December. Inflation will be closely watched, along with a number of indicators including Q4 GDP growth and other activity indicators. **Market impact:** a higher-than-expected inflation outturn or faster activity indicators for December could unnerve markets by increasing expectations of additional tightening measures.

Brazil: SELIC Interest Rate (January 19th)

Forecast: 11.25%	**Consensus:** 11.25%	**Previous:** 10.75%

Comment: Following its previous communication, the Central Bank is expected to start to tight the monetary policy next week. We expect the SELIC to be adjusted up by 50bps to 11.25%. The chances of leaving the rate unchanged are minimal in spite of the additional pressures a monetary tightening would impose on the exchange rate. **Market Impact:** Markets will look for any hints about the total size of this monetary tightening cycle as forecasts are currently widespread. Any comments about the weight the monetary authority will attach to the exchange rate issue could also have an impact.

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				Close	Weekly change	Monthly change	Annual change
Interest Rates	(changes in bps)	US	3-month Libor rate	0.30	0	0	5
			2-yr yield	0.57	-2	-10	-29
			10-yr yield	3.27	-5	-26	-41
		EMU	3-month Euribor rate	1.01	1	-2	33
			2-yr yield	1.13	27	7	0
			10-yr yield	3.01	14	-2	-25
Exchange Rates	(changes in %)	Europe	Dollar-Euro	1.339	3.6	0.8	-6.9
			Pound-Euro	0.84	1.4	-1.1	-4.8
			Swiss Franc-Euro	1.29	3.3	0.8	-12.6
		America	Argentina (peso-dollar)	3.98	0.0	0.1	4.7
			Brazil (real-dollar)	1.68	-0.3	-1.1	-5.1
			Colombia (peso-dollar)	1876	0.2	-1.7	-4.8
			Chile (peso-dollar)	491	-1.3	3.6	0.4
			Mexico (peso-dollar)	12.10	-1.3	-2.6	-4.9
			Peru (Nuevo sol-dollar)	2.79	-0.6	-1.1	-2.3
		Asia	Japan (Yen-Dollar)	82.69	-0.3	-1.6	-8.9
			Korea (KRW-Dollar)	1116.75	-0.6	-3.7	-0.9
			Australia (AUD-Dollar)	0.990	-0.4	0.0	7.2
Comm.	(chg %)		Brent oil ($/b)	98.6	5.6	6.9	27.9
			Gold ($/ounce)	1364.5	-0.4	-1.2	20.7
			Base metals	591.5	1.6	3.1	19.4
Stock Markets	(changes in %)	Euro	Ibex 35	10338	8.1	3.3	-12.7
			EuroStoxx 50	2909	3.6	2.4	-1.1
		America	USA (S&P 500)	1285	1.1	4.0	13.1
			Argentina (Merval)	3540	-0.2	7.6	49.3
			Brazil (Bovespa)	70923	1.2	4.5	2.8
			Colombia (IGBC)	15265	1.1	-0.6	30.3
			Chile (IGPA)	23214	0.0	0.0	33.8
			Mexico (CPI)	38134	-1.2	1.2	18.2
			Peru (General Lima)	22186	-3.2	1.0	46.9
			Venezuela (IBC)	65918	0.3	1.6	9.3
		Asia	Nikkei225	10499	-0.4	1.8	-4.4
			HSI	24283	2.5	5.7	12.1
Credit	(changes in bps)	Ind.	Itraxx Main	106	-7	2	31
			Itraxx Xover	416	-25	-25	3
		Sovereign risk	CDS Germany	60	2	8	28
			CDS Portugal	496	-37	58	365
			CDS Spain	308	-45	-11	181
			CDS USA	42	1	3	---
			CDS Emerging	202	-3	-15	-44
			CDS Argentina	541	-42	-107	-466
			CDS Brazil	107	-4	-8	-21
			CDS Colombia	108	-4	-8	-36
			CDS Chile	81	-3	-6	17
			CDS Mexico	111	-3	-7	-22
			CDS Peru	106	-4	-14	-24

Source: Bloomberg and Datastream

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