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Weekly Watch

Global

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Economic Analysis

Financial Scenarios
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Good step, but not enough

- **Hopes are building on expectations that EZ authorities will take additional steps to tackle the sovereign crisis**
  Now that Slovakia has backed the enhancement of the EFSF and after a favourable the assessment of the "Troika" on the fifth review of the Greek plan, the 6th tranche of the loan is "most likely" to be disbursed soon, more should be done. Politicians are increasingly focused on a bank recapitalization plan, but in our view the most important thing is to focus on a comprehensive plan to address the root of the problem (sovereign crisis). In this sense, the President of the European Commission (Mr. Barroso) has announced a welcome road map to address the crisis; yet, high uncertainty remains on the clarification of the details about each proposal, especially on "the Euro area's backstops against the crisis".

- **Emerging economies show signs of moderation (at a faster-than-expected pace) on weakening external demand**
  Weak external demand is affecting Chinese exports and industrial production in both Brazil and Mexico. Despite a lower financial risk premium, emerging markets are rebounding moderately due to ongoing global growth concerns.

- **Additional steps are unlikely in the near-term, but the Fed is prepared to act if necessary**
  The FOMC minutes indicate a modest downgrade of the staff outlook, significant downside risks to growth along with high forecast uncertainty, and subdued inflation over the next few years (ie, at or below the Fed's mandate). Most participants agreed that the FOMC should use more forward policy guidance in its communications to the public, but several participants expressed concern that certain types of forward guidance "could be mistaken for a statement of its longer-run objectives." Thus, despite this the Fed is prepared to take additional steps if necessary, given that further stimulus -beyond the necessary to complete the announced Operation Twist- are unlikely in the near-term. Some kind of communication change could potentially be the next Fed's move.

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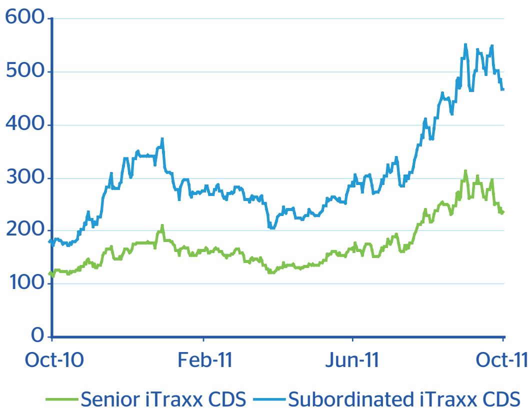
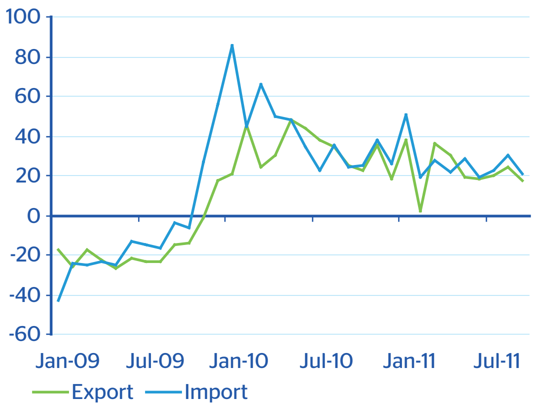
Chart 1
European Financial 5Y CDS



Source: Bloomberg and BBVA REsearch

Chart 2
Chinese Export and Import (Y/Y growth)



Source: Bloomberg

Economic Analysis

Hopes are building on expectations that EZ authorities will take additional steps to tackle the sovereign crisis

For the first time in several months, hopes that European policy makers will take additional steps to tackle sovereign crisis are building. Slovakia has backed the enhancement of the EFSF, which pave the way for the increase of the lending capacity of the EFSF along with expanded powers to buy sovereign debt (both in primary and secondary markets) and provide fund to recapitalize banks. The assessment of the "troika" on the fifth review of the Greek plan was positive, thus the 6th tranche of the loan should be disbursed soon. The President of the European Commission (Mr. Barroso) has announced a (comprehensive) road map to address the crisis. Mr Barroso's proposal lay out simultaneous action along various fronts: 1) a clear response to the problems of Greece, 2) Strengthen the euro's firewalls to contain contagious risk, 3) strengthen the banking sector, 4) frontload policies that consolidate stability and boost growth and 5) advance in the European governance (including the need to assess and develop options for "stability bonds" as part of the arsenal of policy instruments for the Euro area).

Greek financing needs have increased due to the slippage from public deficit and the difficulties to sell assets (to privatize), in this sense, a reassessment of the second rescue program to Greece is needed, including the PSI. Barroso's proposal for bank recapitalization is in line with Germany's approach. First, banks have to raise capital themselves. If they can not, then they would have to ask for it to national governments. Lastly, if governments can not afford to recapitalize banks, the EFSF would provide loans to governments to be used for that purpose and under strict surveillance. Despite the recent focus on the bank recapitalization plan, in our view, it is crucial to dispel uncertainties about European systemic countries with liquidity problems. Thus, greater flexibility and more effectiveness of the EFSF are both needed. The most likely channels to increase the firepower of the EFSF is by either issuing guarantee government issuances or by using the EFSF bonds as collateral for government bond issuances. In this context, Mr Barroso's proposal supports "maximizing the use of the EFSF", but there is a lack of details on it. Additionally front-loading of stability and growth enhancing measures should help to improve confidence in the euro zone, but we have to wait until additional details are announced in order to evaluate the impact.

All in all, the positive news from the Commission's proposal is that it sets a road map to address the crisis. Yet, high uncertainty remains on two fronts: the clarification of the details about each proposal, especially on "how to enhance the Euro area's backstops against the crisis". The ECB has warned, once again, that any write-down on government debt that causes bondholder losses could damage the currency and the region's banking system-.

China, Brazil and Mexico show signs of moderation on weakening external demand

In spite of financial risk premium easing, growth driven assets from emerging markets have not outperformed this week as concerns about the global growth outlook have not dispelled. China's exports for September grew by a weaker-than-expected 17.1% y/y, a clear sign of weakening external demand. Import growth remained buoyant (in volume terms) on sustained domestic demand, The weaker export outturn led the customs bureau to warn of "challenges ahead", and the currency depreciated for the day, despite rising trade and currency tensions with the US. Meanwhile, industrial production and retail sales in both Brazil and México surprised on the downside, suggesting that both economies are beginning to show the first signs of the market turmoil related concerns. Price pressures remain high in both Asia (Chinese CPI is still in the 6.1%) and Latin-American countries, with the exception of Mexico where inflation surprises continue to be on the downside. The combination of still high inflation and weakening activity presents a challenge to the authorities. In the case of China, we expect monetary policy to remain on hold in the near term to contain inflation expectations, with support for growth coming through targeted fiscal measures, including stepped-up spending on social housing. Nevertheless some of the Asian region's policy makers have begun to implement policy measures to support growth. Bank Indonesia cut interest rates by 25 bps at its monthly policy meeting this week, and the Monetary authority of Singapore today eased its policy stance by slowing the appreciation path for the SGD. Nevertheless, most policymakers are still in wait-and-see mode and, with monetary conditions already quite lax and inflation running high, we do not expect further significant easing in the near term (Korea, for example, left rates unchanged this week). On the other hand, the step taken by Brazilian authorities suggest they will attempt to counteract the slowdown by easing monetary policy. Lastly, Banxico left interest rates unchanged but signaled that it was ready to cut rates.

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Markets

Forex: EURUSD squeezes higher

EURUSD has steadily rallied since the October 7 close. Simply put, we do not believe the rally in EURUSD has been entirely fundamentally driven; instead, we believe the move is somewhat a result of a classic FX market "short-squeeze." A short-squeeze typically occurs when the market becomes very short of a currency in a relatively quick period of time. Specifically with EUR, non-commercial accounts according to the latest CFTC data went from a neutral position to an extreme net-short position between the end of August and the third week of September – a quick move by historical standards. After holding at around the same level for the following two weeks the FX market found itself caught too short, too quickly with non-commercial accounts taking profit on short EURUSD and EUR-cross trades. Cascading stops through the mid-1.30s in EURUSD helped propel the pair back above 1.3800 on October 12 after trading below 1.3200 on October 4.

Importantly, the bulk of the short-squeeze looks to have now materialized and if EURUSD were to test 1.4000 we do not believe it would be driven by the same rationale; fundamentals are likely to come back to the fore. The upcoming EMU meeting originally slated for October 18 and now scheduled for October 23 has the potential, we believe, to be a significant market event with the push-back in meeting date likely exacerbating FX market expectations for a "successful" and "concrete" resolution to the peripheral crisis.

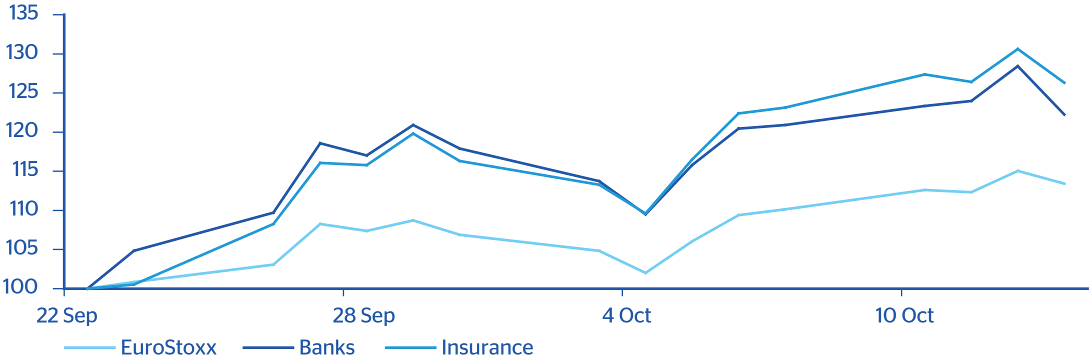
Credit: Reopening of the primary market

Last week Fitch joined other rating agencies in downgrading Spain and Italy's credit ratings. The subsequent repercussions were felt by Italian and Spanish banks and some Spanish companies and autonomous communities. Despite the negative newsflow from the rating agencies, on Thursday the market opened with the first new issues by Spanish and Italian companies since the summer. Iberdrola and Telecom Italia issued new debt for periods of close to five years and these issues were favourably received by the market, offering spreads of about 290 and 500 basis points, respectively. The issues were oversubscribed between four and five times.

European Equity have already priced in the success of this recapitalization process

The recapitalization process of the European banking system gains momentum. We think there are 2 main risks: i) execution risks, in fact some top European banks have stated that they would rather sell assets than raise expensive new capital, something which will delay the solution to the funding problem; and ii) more importantly, risks linked to the valuation of the asset side of the different banks' balance sheets - if this valuation process is a kind of "stress test version 3.0" in which assets are not fully marked to market, then it is unlikely to calm financial markets. So be cautious: European equities have already priced in the success of this recapitalization process, but it is still to be seen how and when this will be done. The EuroStoxx has soared 18.5% in just 3 weeks, led by Financials (+29.5%) and, more recently, by cyclical high-beta sectors such as Autos and Basic Resources.

Chart 3
EuroStoxx vs. Banks and Insurance



Source: Bloomberg and BBVA Research

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Calendar: Indicators

Eurozone: Flash consumers confidence (October, October 20th)

Forecast: -20.3	Consensus: -20.0	Previous: -19.1

Comment: We think that consumers' confidence has deteriorated again in October, remaining below its historical average for the third consecutive month. The lack of determination in the resolution of sovereign debt continues to weigh on consumers expectations about the sustainability of the recovery and, especially, on expectations about a further deterioration in the labor market. This would result in increased concerns about the negative impact on their disposable income and thus would be reflected in lower households' consumption. **Market impact:** Disappointing data could increase market fears about an activity contraction in coming quarters, as the weakness of domestic demand will not take over as a driver of growth in a context of slowing global demand.

Germany: IFO Expectations (October, October 21st)

Forecast: 96.3	Consensus: 97.0	Previous: 98.0

Comment: We expect Ifo expectations to have declined further in October, continuing the downward trend observed in recent months. In addition, this component would have already been below its historical average for the second month in a row, although far from the record-lows observed in late 2008. Given the high correlation of this indicator with the GDP growth, these figures showed further evidence about a bleak economic outlook, even pointing to an activity contraction in the last quarter of the year. We also expect both business confidence and current assessment components to deteriorate further in October, although they will remain above the long-term average. **Market Impact:** As they are the first data available for Q4, figures much worse than expected could negatively affect markets by raising fears of a return to recession instead of a stagnant economy.

US: Industrial Production (September, October 17th)

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

Comment: Industrial production is expected to grow again in September at a similar pace as in August. Exports of goods and services have remained strong despite slowdowns in demand stemming from the sovereign debt crises in Europe. Manufacturing expectations for the coming months have improved, however regional Fed surveys continue to suggest slowing in the manufacturing sector. In addition, monthly auto production declined in September, limiting the upside growth potential for total industrial production. **Market Impact:** Positive industrial production growth will keep markets calm, however surprising setbacks could reignite concerns of a double-dip recession.

US: Consumer Price Index, Core (September, October 19th)

Forecast: 0.2%, 0.2% m/m	Consensus: 0.3%, 0.2% m/m	Previous: 0.4%, 0.2% m/m

Comment: Consumer prices are beginning to moderate after two months of higher-than-expected headline inflation. Rising food and energy prices have driven inflation throughout the summer months, however both appear to have declined slightly in September. The commodity price index has dropped significantly since its peak in April 2011, and low consumer demand should limit runaway food inflation. Continued weakness in economic activity will likely keep headline price pressures in check, with limited pass-through to core inflation. **Market Impact:** The Fed has indicated that inflation will settle within their comfort zone, so worries of rising price pressures are minimal. However, another month of higher-than-expected headline inflation could raise concerns.

China: China GDP for Q3 (October 18th)

Forecast: 9.2% yoy	Consensus: 9.3% yoy	Previous: 9.5% yoy

Comment: As prospects for the global economy remain highly uncertain, markets are focused on activity indicators in China to gauge the resilience of the world's second largest economy, and whether it can continue to serve as a buffer to weaker demand from the US and Europe. In this context, a stream of important indicators, including the Q3 GDP outturn, September industrial production, investment, and retail sales, will be released in the coming week. We continue to hold a soft-landing view, and we expect Q3 GDP growth to moderate slightly. **Market impact:** A higher-than-expected reading would bolster confidence in the outlook, while a weaker-than-expected reading would aggravate worries of a possible hard landing.

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			Close	Weekly change	Monthly change	Annual change
Interest Rates (changes in bps)	US	3-month Libor rate	0.40	1	6	12
		2-yr yield	0.26	-3	7	-10
		10-yr yield	2.22	14	23	-34
	EMU	3-month Euribor rate	1.57	1	4	58
		2-yr yield	0.66	6	10	-15
		10-yr yield	2.20	20	32	-17
Exchange Rates (changes in %)	Europe	Dollar-Euro	1.385	3.4	1.0	-1.2
		Pound-Euro	0.88	1.9	0.8	0.3
		Swiss Franc-Euro	1.24	0.0	3.0	-7.7
	America	Argentina (peso-dollar)	4.22	0.2	0.3	6.7
		Brazil (real-dollar)	1.74	-2.5	0.5	4.7
		Colombia (peso-dollar)	1896	-2.1	3.7	4.9
		Chile (peso-dollar)	500	-3.6	4.4	4.3
		Mexico (peso-dollar)	13.26	-1.2	2.2	6.7
		Peru (Nuevo sol-dollar)	2.72	-1.0	-0.4	-2.6
	Asia	Japan (Yen-Dollar)	77.33	0.7	0.8	-4.9
		Korea (KRW-Dollar)	1156.73	-1.8	4.4	4.2
		Australia (AUD-Dollar)	1.030	5.6	0.7	4.0
Comm. (chg %)		Brent oil ($/b)	114.6	8.2	1.9	39.0
		Gold ($/ounce)	1680.9	2.6	-7.6	22.8
		Base metals	539.4	0.3	-5.3	-0.1
Stock Markets (changes in %)	Euro	Ibex 35	8976	2.0	11.6	-17.4
		EuroStoxx 50	2355	3.8	13.1	-17.1
	America	USA (S&P 500)	1217	5.3	2.3	3.4
		Argentina (Merval)	2667	14.7	-3.0	-2.5
		Brazil (Bovespa)	54779	6.9	-2.7	-23.7
		Colombia (IGBC)	13395	4.1	-1.2	-12.5
		Chile (IGPA)	19304	3.4	-1.0	-12.8
		Mexico (CPI)	34817	5.5	0.4	0.2
		Peru (General Lima)	18882	6.3	-6.4	-2.1
		Venezuela (IBC)	100118	0.1	-0.7	51.2
	Asia	Nikkei225	8748	1.7	2.7	-7.9
		HSI	18502	4.5	-2.9	-22.1
Credit (changes in bps)	Ind.	Itraxx Main	178	-11	-5	77
		Itraxx Xover	765	-48	23	295
	Sovereign risk	CDS Germany	94	-5	9	61
		CDS Portugal	1135	16	1	777
		CDS Spain	373	4	-3	172
		CDS USA	48	-2	-3	---
		CDS Emerging	310	-36	1	109
		CDS Argentina	957	-155	76	229
		CDS Brazil	157	-27	-14	60
		CDS Colombia	157	-31	-14	58
		CDS Chile	130	-18	14	64
		CDS Mexico	154	-29	-16	49
		CDS Peru	160	-28	-16	60

Source: Bloomberg and Datastream

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