BBVA | RESEARCH

Weekly Watch
Global

Madrid, 15 April 2011
Economic Analysis

Financial Scenarios
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Searching for clues

Now that the ECB has made its first interest rate increase and the Fed has confirmed the end of Q2 in June, as planned, investors are trying to predict the path of monetary policy tightening by searching the economic data for any hint that the spike in oil prices may be impacting either inflation or growth expectations. In EM, economic data are also being closely watched to confirm policy measures' success in hampering overheating.

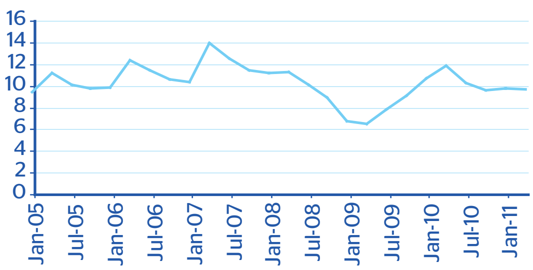
Growth momentum remains intact in Asia, but eases in major economies

The IMF WEO report has not helped to clarify uncertainties. It confirms that the recovery is gaining strength, but it sees downside risk from higher commodity prices. In all, projections for global growth in 2011-12 have barely changed. Recent real data indicates that growth momentum in Asian countries continues surprising to the upside. First quarter GDPs in China and Singapore were stronger-than-expected which, together with rising inflation, has raised expectations of further tightening and currency appreciation. Activity growth in major Latam countries provides early signs of moderation. In advanced economies, data suggests that economic recovery remains on track, but that these countries will face slower or non-accelerating growth over the next few quarters. EZ Industrial production increased less than anticipated in February, while the German ZEW dropped in April. The US Beige Book confirmed that activity is expanding in all districts, and core retail sales have risen sharply. On the other hand, inflation has been driven up by higher commodity prices. Yet, indirect effects have had a limited impact on core inflation as a result of higher energy prices in Europe. In the US, commodities have put upward pressure on prices, but there are no signs of increasing price pressure from wages.

Orthodox tone from ECB official while Fed just wants to anchor expectations

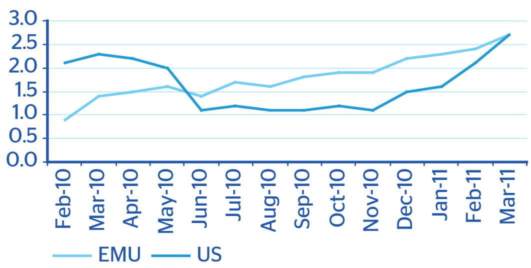
This week, ECB officials Draghi and Weber have maintained their hawkish tones after the rate hike. Albeit Fed's voting members acknowledge the risks that could prompt an earlier than expected tightening of monetary policy –and in that way contribute to the continued anchoring of inflation expectations–, they remain convinced that underlying inflation will remain subdued, and thus, the stance of monetary policy will remain in place for longer ("is still appropriate"). Additionally, the bi-partisan agreement on budget cuts prevented a US government shutdown, but now the fight turns to the debt celing. On the other hand, solvency problems in some European peripheral countries will maintain uncertainties in the markets unless it is resolved, but we do no think this will come any time soon (see highlight). **Next week** in the EZ the April PMI index and the March US housing data will be released.

Chart 1
Chinese Real GDP (Y/Y growth)



Source: Bloomberg

Chart 2
CPI (Y/Y changes)



Source: Bloomberg

Highlights

China's first quarter GDP and inflation surprise to the upside

Stronger than expected growth and inflation reinforce expectations of more tightening.

Renewed doubts on the periphery

The solvency problems of some Peripherals introduce some noise.

Event calendar in peripheral countries

Event-driven market.

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Markets

Interest Rates: Uncertainty over the path the ECB will take

Following the “expected” ECB rate hike at the April meeting, the source of uncertainty is now the rate at which it will implement new hikes. The market is therefore split into two factions. On one hand there are those who believe that this rise was pre-emptive (an opinion we share, since we only expect one further rate hike in July 2011), and aimed at anchoring expected inflation following the rises in commodity prices. On the other hand are those who think this is the start of a cycle similar to the one seen in 2005, with quarterly rate hikes. In this regard, the statement by Trichet (‘we do what we have to do.’) has meant that the market is focusing on macroeconomic data to try and confirm whether or not the ECB will make a move. Import figures for Germany, wholesale prices and euro zone inflation have all brought volatility to the short ends of curves, with a slight upward bias.

Equity: Battling strong headwinds, but there is value in equities

Having updated our valuations of the main equity indexes, in our view the index with the most potential over the remainder of the year is the EuroStoxx 50. Our target is 3,800 points, a level which may seem distant at present, but which will appear less so if the economic cycle is not severely affected by oil, and if financials perform well in the second half of the year. The index with the least potential at present seems to be the S&P 500, with a target of 1.450 points.

As already mentioned, the key to this year is how the financial sector performs. We therefore see a lot of appeal in the insurance sector, since interest rate curves have already started to rise and because in Europe it is trading at P/E 11e 8x. However, the banks have the real influence on indexes, and in the short term their recommendations are subject to more uncertainty, as there is a possibility of capital increases (Basel III and Stress Tests in June 11). Having said all of this, even though future ROEs will be lower due to regulations, valuations are attractive (P/Book <1 in Europe) and it is important to note that senior (and subordinated) debt has narrowed from 210bp to 130bp YTD in 2011, pointing to better times for the banking industry.

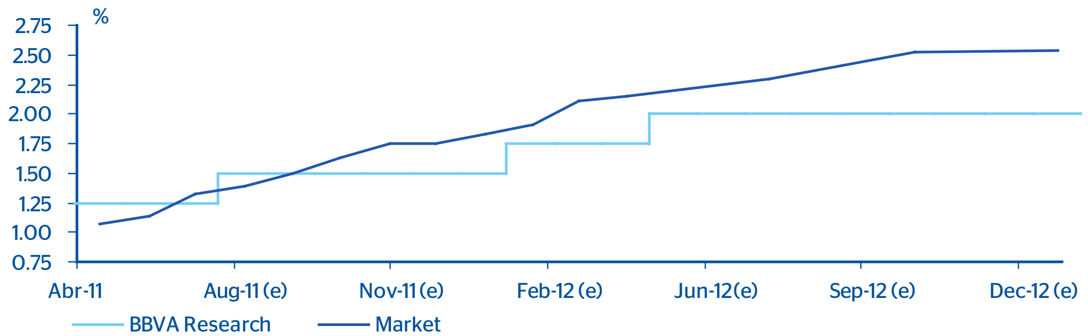
Credit: further noise from the periphery boosts some widening

On credit markets, following the rally at the start of the month this week we have seen widening across the board in synthetic indexes. The iTraxx Main widened 3bp, while the iTraxx SovX widened 14bp from the lows reached last week. In financials the iTraxx Fin Senior widened 8bp, and the iTraxx Fin Sub 20bp.

Among the peripheral countries, although there has been a clear decoupling between Spain's performance and that of the rest, we have seen some weakness in Spanish bonds following the statements made by the German finance minister concerning the possibility that Greece may need to renegotiate its debt if auditors were to question the Greek government's ability to meet its credit obligations. For example, the Spanish 5Y CDS has widened 30bp to 227bp so far this week, while Portugal and Greece's 5Y CDS's widened 54bp and 90bp respectively, to 593bp and 1112bp.

On the primary market, we would highlight the issues by UBI Banca, Société Générale and Credit Agricole. On the secondary market, corporates are continuing to trade at very narrow levels, and announcements by companies of increased capex and dividend payouts make us think that entities currently have sound cash positions, which explains the decline in their issuance. In financials, following the strong rally on the back of the results of the stress test on Irish banks, we are seeing some stabilization. In our view, the main driver for financials will be the results of the EBA stress tests on the European banking sector. However, we still expect financials to outperform corporates.

Chart 3
Implied rates from Eonia Swap curve vs BBVA Research



Source: Bloomberg & BBVA Research estimates

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Highlights

China's first quarter GDP and inflation surprise to the upside

First quarter GDP and inflation data point to continued strong growth in the Chinese economy with underlying price pressures. In particular, Q1 GDP growth registered 9.7% y/y (BBVA: 9.3%), down slightly from the previous quarter (9.8% y/y). Headline inflation rose to 5.4% y/y in March (BBVA: 5.0%) from 4.9% in February, due to both rising food and non-food prices. Producer price inflation (PPI) in March also edged up to 7.3% y/y from 7.2% y/y in February on rising commodity prices, marking a fourth straight month of increases in the reading. The outturns explain why the authorities have been so aggressive in tightening monetary policy in the past months and weeks, and expectations of further tightening measures may intensify, which could weigh on market sentiment. There are upside risks to our expectations of one more 25bp rate hike and further hikes of at least 100bp in the required reserve ratio in the coming quarters. A positive interpretation of today's data, however, is that growth remains robust, even as the authorities implement measures to tame inflation. Recent credit growth data are showing an encouraging slowdown--new loans for all of Q1 were RMB 2.2 trillion, broadly in line with what we believe to be the authorities' (unannounced) full-year target of RMB 7.0-7.5 trillion.

Renewed doubts on the periphery

The framework for solving stress in European peripheral countries is far from perfect, despite the agreements reached at EU council level. Doubts regarding this framework's sustainability have arisen this week. First and foremost, declarations by German finance minister W Schäuble suggested that restructuring Greek debt is an option. These statements join reports of a meeting between several EZ finance ministers and Mr Trichet last weekend where Mr Trichet and Mr Schäuble demonstrated differing views on the issue (the latter apparently said that a bail-in would not imply a major risk of contagion). Additionally, there are tensions in Finland ahead of this weekend's elections, where the issue of approving Portugal's rescue package (which requires a parliamentary vote in Finland and unanimity across EZ countries) is prominent in the campaign. Also, in Germany news on possible legal and political hurdles to reduce future contributions to the European rescue fund have arisen. Nevertheless, we think in the end any problems to provide the necessary aid to Portugal through the EFSF will be solved. However, the solvency problems of Greece and eventually other countries have not been solved. Since the EU is far from any solution involving more fiscal integration or burden sharing through Eurobonds, the only alternative to a potential bail-in from private investors is if Greece succeeds in reducing its deficit and recovering growth. However, this is far from certain, and will require time.

Event calendar in peripheral countries

Upcoming events in the next few months could have a significant effect on European sovereign risk premium. At the end of this month, the Spanish government is set to approve a reform on collective bargaining. On April 26th, Eurostat will publish the estimated deficit and debt for 2010, and each of the European governments will have to present its Stability Growth Pact, which includes the deficit trend for the coming years. By mid-May, Portuguese, European and IMF authorities will agree on a Portuguese bail-out pact, but financial aid will not be ready until the new government has been elected, introducing high uncertainty ahead of the €4.9bn Portuguese bond redemption on June 15th. In Spain, two important events will take place in May: the local and regional government elections on the 22nd, and the release of the first quarter regional government budget figures by the end of the month. June will be a very busy month. On June 5th, Portugal will hold general elections and a new prime minister will be appointed as early as June 20th. It is important to note that Portugal faces a bond redemption on June 15th. On June 9th the ECB will decide on the extraordinary liquidity measures, but we expect that the ECB will not hike rates again until July. Regarding European governance, we expect an explicit resolution and more details on the ESM & EFSF frameworks at the EU government council meeting on June 24th. It is also expected that candidate for ECB president will be announced at the June 24th Council. Additionally, the second European bank stress test will be released in June. Finally, on June 18th the Spanish government will make an "Austrian fund" proposal (an unemployment fund for each worker which is contributed to by companies in which he or she has worked).

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Calendar: Indicators

Eurozone: PMI Composite (April, April 19th)

Forecast: 57.1	Consensus: 57.1	Previous: 57.6

Comment: The PMI composite is expected to decline further in April, partly reflecting the expected negative impact of higher commodity prices and interest rates hikes on economic sentiment, but also because the strong momentum in Q1 is unlikely to remain. This would imply increased uncertainty on the economic outlook for coming months. Across components, we see industrial sentiment declining again driven by the slowing sector recovery, although it should be partly offset by some resilience in service confidence. **Market Impact:** A strong decline in PMI data could affect negatively to markets, as a deterioration of confidence could lead to a sharper slowdown than currently priced.

Germany: Industrial inflation (March, April 20th)

Forecast: 0.7% m/m	Consensus: 0.8% m/m	Previous: 0.6% m/m

Comment: Industrial prices are expected to increase further in March mainly driven by higher energy prices. Despite the strong upward trend observed since the beginning of 2010, the industrial price index still remains slightly below levels observed at the end of 2008. Overall, industrial inflation shows further evidence of inflationary pressures resulting from higher input prices, but there are no signs of imminent second round effects, as wage bargaining is still moderate. **Market impact:** A sharp increase in industrial inflation could be interpreted as further evidence of higher indirect effects on consumer inflation in coming months, arising concerns on a tighter monetary policy stance by the ECB.

US: Existing Home Sales (March, April 20th)

Forecast: 4.95mn	Consensus: 5.00mn	Previous: 4.88mn

Comment: Recent real estate indicators raise questions about the fundamentals of the housing sector. The negative trend in home prices, weak home sales and elevated rate of foreclosures show that the residential sector will remain depressed at least through the first half of 2011. Although existing home sales had started to recover in late 2010, recent data show that the existing home market remains depressed. We expect existing home sales to increase in March after dropping dramatically. Nevertheless, current market conditions remain favourable for home buyers and these conditions will help support home sales in the second half of the year. **Market impact:** A further decline in existing home sales would increase the chances of a double-dip in the housing market and increase pessimism in financial markets.

US: Initial Claims (April 16th, April 21st)

Forecast: 395K	Consensus: 390K	Previous: 412K

Comment: Labour markets are improving but at a gradual pace. Last month, the unemployment rate declined further by 0.1pp to 8.8% and non-farm payrolls increased by 216K in March. Since February 2010 the U.S. economy has created 1,492K new jobs. The most recent jobless claims report indicates that initial unemployment claims increased to 412K in the week ending April-8 while continuing claims declined slightly to 3.68mn. Although initial claims increased, the 4-week moving average remained below 400K. This is the seventh consecutive week with the 4-week moving average below 400K. However, initial claims have to remain below 375K in order to see sustainable and robust employment growth in non-farm payrolls. We expect initial claims to remain around 400K. **Market impact:** If initial claims jump unexpectedly it would indicate deterioration in labour market conditions and negatively affect financial markets.

Japan: Export growth in (March, April 20th)

Forecast: 5.3% y/y	Consensus: -0.7% y/y	Previous: 9.0% y/y

Comment: Japan's exports and imports are likely to have been disrupted in the aftermath of the earthquake. Exports for March, although only partially reflecting the full-month impact, will offer a first glimpse of the magnitude of the supply shock. So far trade data from Japan's most significant trading partners in Asia (such as Taiwan) show a strong impact. Japan's exports in March are expected to have fallen from the levels of previous months. **Market impact:** A better-than-expected outturn might lift market sentiment, while a lower-than-expected outturn could exacerbate concerns about the impact not only on Japan, but for the region.

Markets Data

			Close	Weekly change	Monthly change	Annual change
Interest Rates (changes in bps)	US	3-month Libor rate	0.27	-1	-3	-3
		2-yr yield	0.72	-9	17	-23
		10-yr yield	3.42	-15	25	-34
	EMU	3-month Euribor rate	1.33	4	16	69
		2-yr yield	1.85	-6	37	96
		10-yr yield	3.38	-10	29	30
Exchange Rates (changes in %)	Europe	Dollar-Euro	1.440	-0.2	3.7	6.7
		Pound-Euro	0.88	-0.1	1.5	0.5
		Swiss Franc-Euro	1.29	-2.0	2.0	-10.1
	America	Argentina (peso-dollar)	4.07	0.3	0.7	5.1
		Brazil (real-dollar)	1.58	0.3	-5.6	-10.4
		Colombia (peso-dollar)	1800	-0.9	-4.9	-7.4
		Chile (peso-dollar)	473	0.6	-2.7	-9.6
		Mexico (peso-dollar)	11.73	-0.1	-3.2	-4.5
		Peru (Nuevo sol-dollar)	2.82	0.7	1.8	-0.5
	Asia	Japan (Yen-Dollar)	83.18	-2.1	3.9	-9.6
		Korea (KRW-Dollar)	1087.85	0.4	-4.5	-2.4
		Australia (AUD-Dollar)	1.054	0.1	7.4	14.0
Comm. (chg %)		Brent oil ($/b)	122.4	-3.4	10.6	42.3
		Gold ($/ounce)	1475.0	0.0	5.4	29.7
		Base metals	633.9	-0.3	4.6	23.5
Stock Markets (changes in %)	Euro	Ibex 35	10538	-3.4	4.4	-6.4
		EuroStoxx 50	2914	-2.4	7.1	-1.2
	America	USA (S&P 500)	1317	-0.8	4.8	10.5
		Argentina (Merval)	3382	-2.8	5.8	41.0
		Brazil (Bovespa)	66682	-3.0	1.0	-3.9
		Colombia (IGBC)	14071	-3.3	1.4	13.8
		Chile (IGPA)	22200	-0.7	7.1	24.8
		Mexico (CPI)	37070	-1.1	4.0	10.3
		Peru (General Lima)	18698	-12.0	-10.9	20.8
		Venezuela (IBC)	70477	0.2	0.9	16.1
	Asia	Nikkei225	9592	-1.8	5.5	-13.6
		HSI	24008	-1.6	5.8	9.8
Credit (changes in bps)	Ind.	Itraxx Main	97	2	-8	17
		Itraxx Xover	369	11	-40	-44
	Sovereign risk	CDS Germany	44	6	-1	9
		CDS Portugal	592	54	82	399
		CDS Spain	220	22	-8	71
		CDS USA	42	1	-1	---
		CDS Emerging	201	9	-23	-10
		CDS Argentina	558	9	-104	-286
		CDS Brazil	108	3	-12	-7
		CDS Colombia	101	-1	-19	-30
		CDS Chile	60	2	-13	-19
		CDS Mexico	101	2	-13	-3
		CDS Peru	153	23	31	41

Source: Bloomberg and Datastream

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