BBVA | RESEARCH

Weekly Watch

Global

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Economic Analysis

Financial Scenarios
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Rush to reach agreements

Financial strains in the European periphery have spread to Italy. Neither the approved fiscal austerity package nor the fact that the Italian Treasury managed to sell bonds, and thus meet its allotment's target (EUR5bn), has reduced tensions. Further contributing to tensions, Moody's downgraded Ireland's debt credit rating to Ba1 from Baa3, citing the same reasons as used last week in Portugal's downgrade (the eventual need of a second aid package with private sector participation). Meanwhile, an agreement on comprehensive new measures to address the Greek solvency problem has not been reached as there are still discrepancies among both European politicians and the private sector. The bad news is that core peripheral spreads are reaching dangerous levels. However, the good news is that European leaders are finally trying to address Greece's solvency problem to curb contagion. In our view, this necessary step – which is past due – might be effective as markets could separate countries with solvency problems (Greece) from countries with liquidity problems (Ireland and Portugal). The most effective way to address solvency problems is by reducing the amount of debt. The EU can tackle liquidity problems by providing backstop measures: a higher lending amount and the flexibility to buy government bonds in the secondary market.

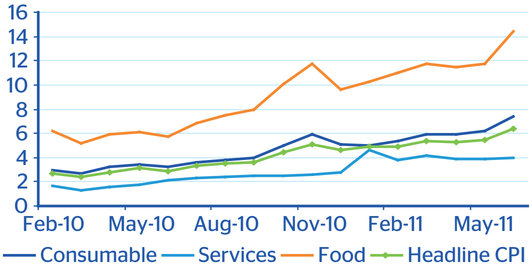
Uncertainties are not just limited to Europe

S&P put the US long-term and short-term sovereign rating on CreditWatch Negative i.e. there is at least a one-in-two chance that it could lower its rating within the next 90 days. S&P's decision rests on fundamental differences on how to address long-term fiscal issues as the risk of a payment default due to the debt ceiling not being raised, albeit increasing, remains small. Thus, within the next 90 days S&P will decide whether the agreement is adequate to address the issue: if it believes that it is, the AAA rating with a Stable Outlook will be reaffirmed; whereas if it decides that it is not, S&P may lower the rating if it believes that a plan to stabilize debt dynamics is unlikely in the next few months.

On the macro side, negative surprises continued in the EZ and the US. Meanwhile, Chinese 2Q GDP allayed concerns of a hard landing. Yet, the higher inflation print poses modest upside risks to our 5% year-average inflation outlook. In Latin-America, growth remains strong despite the moderation seen in some indicators such as Brazil's retail sales. Regarding monetary policy Bernanke remarked that deflationary pressures would have to re-emerge to consider further quantitative easing, while the central bank of Brazil introduced additional measures to attempt to limit appreciation pressures.

Chart 1

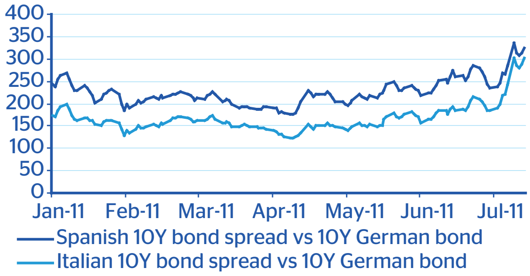
Chinese price pressure remains



Source: Bloomberg

Chart 2

European sovereing risk has spread to Italy



Source: Bloomberg

Highlights

Italy's imbalances are limited, apart from the high debt ratio

The fundamentals of the economy remain relatively solid.

Fed taking a "wait and see" approach

Deflationary pressures would have to re-emerge to consider further quantitative easing.

Country Risk BBVA Research Model

The role of global market and idiosyncratic factors in explaining country risk.

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Markets

Monetary curves are discounting a clear "wait and see" approach

The euro monetary curve has flattened to the point of pricing in no further rate hikes and even an extension of the extraordinary liquidity measures. The 10-month forward on one-month Eonia rates are currently trading at around 1.40%, which not only assumes that there will not be any more rate hikes, but also that full allotment will remain in place, trimming 10bp off the official rate. Meanwhile, the dollar curve is also pricing in this outlook but in a more relaxed and consistent manner; consistent in the sense that although the expected first hike has been pushed back by ¾ months (the first Fed Fund future above 0.5% is February 2013), the 1/2Y slope two years forward has remain stable, with a slight bias towards steepening. The expectation is therefore of an aggressive cycle of tightening from the Federal Reserve, but one which will not start for some time. In our view these movements are the result of an overreaction rather than any change in fundamentals, so we consider this a good time to cover exposure to rate hikes.

Forex markets remain volatile

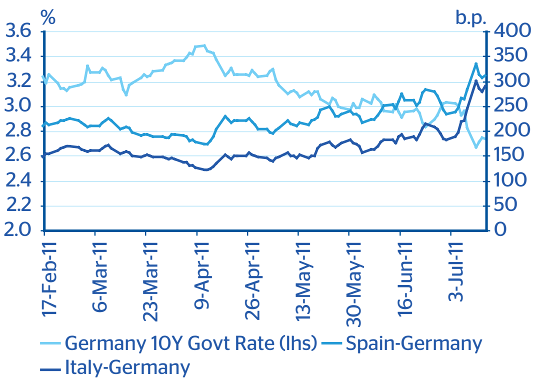
Over the last week, forex markets have again been highly volatile, on the back of newsflow from the EU and US. Certain peripheral European countries' ratings were again downgraded (Moody's cut Ireland's rating to junk, bringing it into line with Portugal; Fitch downgraded Greece), giving rise to fears of a knock-on effect on other countries such as Italy and Spain. In turn, this led to gains in the USD vs. G10 and emerging currencies in a context of risk aversion during the first three days of the week. However, although Bernanke's statement underscored the high level of uncertainty regarding the labour market, it also left the door open for any further quantitative stimuli if needed, which led to a recovery in the main risky assets. Nonetheless, Bernanke still expects a recovery over the remainder of the year, so we do not see a clear rationale for the higher appetite for risk on the back of QE3. As a result, most currencies resumed their positive trends vs. the USD and the DXY index ended up dropping by just 0.1% overall. We therefore expect currencies to remain volatile in the near future, overreacting to any newsflow from the US or EU.

Credit market looking at Stress Test and Rating Agencies

This week, Moody's placed the US's sovereign rating under review for a possible downgrade, thus indicating that there is no longer such an insignificant probability of the US defaulting on its sovereign debt. Whit this and other news from rating agencies this week high volatility has characterised credit markets, especially at the start of the week, with continual changes in direction due to the varying news items coming from peripheral countries; mainly Italy. Thus, last Tuesday the majority of the 5Y CDS of peripheral countries reached highs (except for Spain).

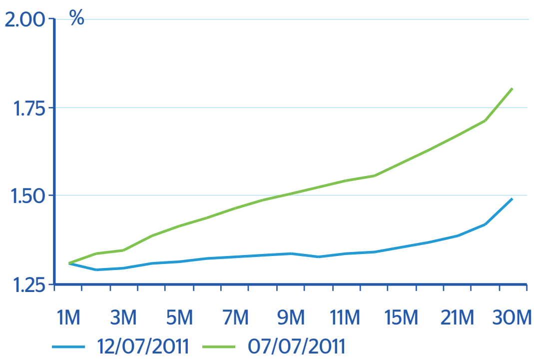
Lastly, today at 6pm the European banks' stress test results are to be released, which should be a major driver for credit markets over the coming days.

Chart 3
Germany 10Y Govt Rates vs Core / Non-core Spreads



Source: Bloomberg and BBVA Research

Chart 4
Eonia Swap Curve



Source: Bloomberg and BBVA Research

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Highlights

Italy's imbalances are limited, apart from the high debt ratio

The recent rise in Italian bond spreads led the government to accelerate the approval of fiscal consolidation measures in order to balance its budget by 2014. Markets have remained unimpressed, due to the backloaded nature of the adjustment –most of the measures are due to take place in 2013 and 2014, after the elections scheduled for mid-2013. However, the fundamentals of the country's economy remain relatively solid: Italy has a high public debt (119% of GDP) and slow growth (potential growth is probably no higher than 1%, which explains why its debt ratio has not fallen during the past decade). However Italy's public debt situation should not get out of hand: household and corporate debt is low, the country has not experienced a housing bubble in recent years; the current account deficit is low (in sharp contrast to Portugal and Greece); and its public deficit, at 4.6% in 2010, is comparatively smaller than those of most Eurozone economies thanks to a prudent fiscal policy during the crisis – with no stimulus in 2009. Higher spreads triggered by funding difficulties could raise the interest bill, but only very slowly. Without structural reforms the economy's pace of growth should remain low and the debt ratio should slowly fall; however, there are no skeletons in the closet (as was the case with Irish banks and Greek public accounts).

Fed taking a "wait and see" approach

Tuesday's release of the FOMC minutes and Bernanke's speech before the financial services committee revealed a more formalised sequencing of the exit strategy, but not of the policy stance or balance sheet. The minutes underlined that this discussion of normalisation is for "prudential planning" purposes only and should not be construed as an imminent sign of exit. Also, the staff review of the economic situation unveiled a focus on two major issues: first, ongoing changes in both survey and market-based inflation expectations, and second, structural unemployment and wage pressures in a "softened" labour market. When taking questions, Bernanke stressed the need for congress to adequately manage the debt ceiling. During his biannual speech regarding monetary policy, Bernanke touched on both the exit strategy and also options for the Fed if economic growth slows considerably, which underscores the debate within the FOMC. According to Bernanke, if deflationary risks re-emerge, the Fed may offer more explicit guidance on the target rate and balance sheet, conduct more securities purchases, and increase the average maturity of the Fed's holdings. However, the Chairman pointed to the untested nature of these choices and their uncertain effects on output. The minutes and Bernanke's biannual monetary policy speech are in line with our expected policy sequencing, excluding the cessation of principal reinvestment, which we expect to be pushed back to Nov-Dec, in anticipation of moderate growth in 2H11 and increasing, but stable, core inflation.

Country Risk BBVA Research Model

Through a model developed by the BBVA Research Emerging Markets Unit, participants at a seminar held by the Unit on 13 July focused on the role of global market and idiosyncratic factors in explaining country risk. Some interesting results were discussed, including the importance of global market conditions in explaining country risk, which may become an important driver. Among the roles of idiosyncratic factors the model highlights the role of the fiscal situation as a key driver. The external sustainability indicator also matters and has become increasingly more important more recently. The contribution of institutional variables does not seem to be homogeneous across the board, with a very low contribution in developed markets, but increasing relevance in some of the emerging markets. The results also highlighted some differences in terms of the current situations of European countries: core stable countries (with low and near equilibrium CD swap levels), highly distressed countries (with high levels of risk, but which are also near equilibrium) and a third group (with CD Swaps quoting far above the equilibrium). Lastly, according to the model, Emerging Markets remain somewhat overvalued (for more detail see BBVA Research Events).

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Calendar: Indicators

Eurozone: flash PMI composite (July, 21 July)

Forecast: 52.4	Consensus: : 52.5	Previous: 53.3

Comment: we expect the composite PMI to decline further in July, although at a much lower pace than in previous months and remaining in expansionary territory. This said, manufacturing sentiment is expected to fall sharper than services, as the upswing in the latter seems to be more sustainable. In addition, the recent increase in uncertainty over the sovereign debt crisis and its resolution could end up weighing heavily on confidence. Overall, these figures would imply that the eurozone economy has grown at steady rates at the beginning of 3Q, at a slower pace than at the beginning of the year. This declining trend is expected to be observed across member states, with persistent divergence between the core and the periphery. **Market Impact:** as the first indicators for 3Q, a negative surprise could significantly affect markets, pricing in a further deceleration in activity.

Eurozone: industrial new orders (May, 22 July)

Forecast: 0.4% m/m	Consensus: 0.8% m/m	Previous: : 0.8% m/m

Comment: we expect industrial new orders to have increased moderately in May, with the pace slowing since 1Q. Soft data also showed that orders in the manufacturing sector, both domestic and from abroad, worsened significantly in May and June. Overall, these figures show further evidence of the weakness of the industrial sector recovery that continues to rely on demand from emerging economies. **Market impact:** a sharp drop in industrial orders could raise doubts about the sustainability of the recovery in the second half of the year.

US: housing starts (June, 21 July)

Forecast: 567k	Consensus: 575k	Previous: 560k

Comment: oversupply and tight credit are likely to suppress housing starts again in June, however strong housing permit issuance in May could be an indication that housing starts will increase. Even though multi-unit constructions are on an upward trajectory, single unit constructions are declining and should partially offset the impact of multi-unit gains. Overall, construction of new homes has been discouraged by weak residential mortgage demand, tight credit conditions, and growing supply. **Market impact:** since we are expecting just slight MoM gains in housing starts, the market impact should be minimal. However, if the indicator is significantly above or below expectations, markets could react strongly.

US: Jobless Claims (15 July, 21 July)

Forecast: 425K	Consensus: 403K	Previous: 405K

Comment: Initial jobless claims for the week ending 15 July are expected to remain relatively unchanged. Last week's figure of 405K was lower than expected given that the shortened working week is likely to have contributed to fewer claims. The 4-week moving average also dropped slightly last week, from 427K to 423K, but we expect this to adjust accordingly. Looking forward, it is unclear whether the decrease in initial jobless claims is an indication of improvements in the job market. Thus, we expect jobless claims to stay in line with the average at 425K. **Market impact:** we do not expect markets to be moved by minimal changes in initial jobless claims, although markets may respond favourably if claims continue to fall.

Japan: export growth (June, 21 July)

Forecast: -4.2% y/y	Consensus: -4.9% y/y	Previous: -10.3% y/y

Comment: Japan's activity indicators are showing signs of a rebound, in some cases more quickly than expected, as production and supply chains resume after the 11 March earthquake and tsunami. The auto sector is restoring facilities and hiring workers to return capacity back to normal levels. Exports and industrial production appear to have bottomed out in April, setting the stage for a recovery that began in May, and which we expect to continue in June. That said, the outlook remains uncertain due to the shaky external environment, concerns of electricity shortages, and limits on fiscal policy due to Japan's heavy public debt burden. **Market impact:** a lower-than-expected outturn would reinforce concerns about growth prospects in 2H11.

Markets Data

			Close	Weekly change	Monthly change	Annual change
Interest Rates (changes in bps)	US	3-month Libor rate	0.25	0	0	-27
		2-yr yield	0.35	-4	-2	-23
		10-yr yield	2.92	-10	-4	0
	EMU	3-month Euribor rate	1.61	2	12	75
		2-yr yield	1.20	-26	-31	42
		10-yr yield	2.68	-15	-28	7
Exchange Rates (changes in %)	Europe	Dollar-Euro	1.411	-1.0	-0.6	9.3
		Pound-Euro	0.88	-1.6	-0.2	3.7
		Swiss Franc-Euro	1.15	-3.5	-4.9	-15.2
	America	Argentina (peso-dollar)	4.12	0.0	0.7	4.8
		Brazil (real-dollar)	1.58	0.8	-1.4	-11.7
		Colombia (peso-dollar)	1748	-0.7	-2.0	-7.0
		Chile (peso-dollar)	462	0.0	-1.3	-12.8
		Mexico (peso-dollar)	11.73	0.9	-1.7	-9.4
		Peru (Nuevo sol-dollar)	2.74	0.0	-0.7	-2.9
	Asia	Japan (Yen-Dollar)	79.05	-2.0	-2.2	-8.7
		Korea (KRW-Dollar)	1058.18	0.2	-2.4	-12.9
		Australia (AUD-Dollar)	1.064	-0.9	0.6	22.3
Comm. (chg %)		Brent oil ($/b)	117.1	-1.0	0.0	55.4
		Gold ($/ounce)	1589.3	2.9	3.8	33.2
		Base metals	596.3	-1.1	-1.6	26.9
Stock Markets (changes in %)	Euro	Ibex 35	9475	-4.7	-4.6	-5.2
		EuroStoxx 50	2674	-4.2	-2.1	1.1
	America	USA (S&P 500)	1309	-2.6	3.4	22.9
		Argentina (Merval)	3300	-4.9	1.7	44.5
		Brazil (Bovespa)	59315	-3.6	-3.7	-4.9
		Colombia (IGBC)	13118	-4.5	-6.5	1.5
		Chile (IGPA)	22348	-1.2	2.6	14.3
		Mexico (CPI)	36107	-1.1	2.2	13.6
		Peru (General Lima)	20177	1.3	0.2	45.0
		Venezuela (IBC)	83864	3.2	3.6	29.5
	Asia	Nikkei225	9974	-1.6	4.2	6.0
		HSI	21875	-3.7	-2.1	8.0
Credit (changes in bps)	Ind.	Itraxx Main	120	7	9	2
		Itraxx Xover	447	23	35	-88
	Sovereign risk	CDS Germany	56	10	15	16
		CDS Portugal	1095	72	297	807
		CDS Spain	323	9	35	103
		CDS USA	54	5	2	---
		CDS Emerging	221	13	-5	-24
		CDS Argentina	634	33	18	-289
		CDS Brazil	117	9	2	-9
		CDS Colombia	114	8	5	-22
		CDS Chile	76	2	1	-18
		CDS Mexico	115	8	5	-12
		CDS Peru	129	2	-19	7

Source: Bloomberg and Datastream

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