RESEARCH

Weekly Watch

Global

Madrid, 16 September 2011

Economic Analysis

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Pressures to tackle the sovereign crisis

On the one hand, there are new signs of the vicious circle of sovereign and bank debt which is reflected by bank liquidity stresses, European banks' increased reliance on the ECB (see highlight) and the rating downgrades of French banks. On the other hand, the United States and the BRIC economies have made it clear in recent days that they are concerned about finding a solution to a crisis that has international ramifications. And, lastly, but no less importantly, Germany and France have deemed it necessary to support Greece, enabling it to remain in the Eurozone. Specifically, it seems that the green light will be given to paying Greece the latest tranche of the bailout, which, coupled with the news that PSI could reach an acceptance level of 80%, would remove the biggest threat currently faced by Greece.

In the meantime there are other hurdles to face, such as EFSF approval from national parliaments (scheduled for the beginning of October). Barroso's declarations about Eurobonds could be interpreted positively, but should be treated with caution. Either way, they could certainly mark the start of a process that puts Eurobonds on the European agenda.

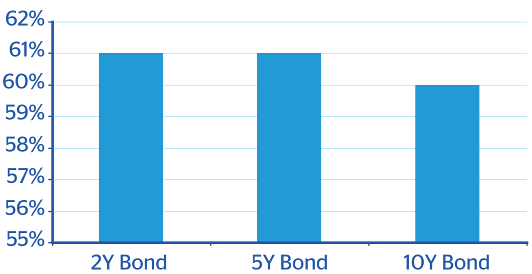
Fed could announce an "Operation Twist"

The latest US economic indicators suggest little improvement over the last month. Consumer confidence levels are close to historical lows and recent retail sales data points to sluggish demand. This has had an impact on the manufacturing sector, while jobless claims have steadily increased since August. Deflation risks have declined further, as inflation has come in higher than expected for two consecutive months. In this context, we expect the Fed to announce an expansion of its long-term Treasury holdings, but no QE3. Stable inflation, grounded inflation expectations, abating deflationary pressures, and growing dissention provide a strong counterpoint to any argument for further quantitative easing in the form of balance sheet growth. In addition, there is no indication the Fed will announce plans to raise or explicitly target inflation, switch to nominal GDP targets, or adjust interest paid on excessive reserves.

Next week the market focus will be on how the European debt crisis develops. On the economic side, the European PMI index for September index and the US housing data will give more clues about the extent of the slowdown in these areas.

Chart 1

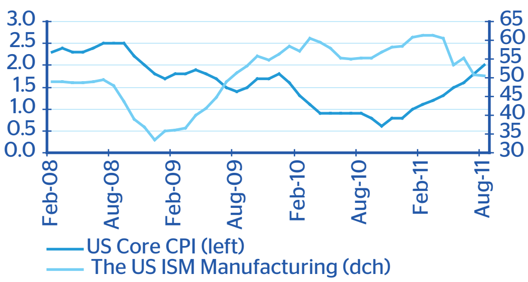
Greek bond haircut implicit in prices



Source: Bloomberg and BBVA Research

Chart 2

US manufacturing activity and inflation



Source: Bloomberg and BBVA Research

Highlights

Funding strains to carry on until underlying concerns are addressed

Concerted measures by global central banks are positive but their effects could gradually fade if worries are not addressed.

Portuguese adjustment programme on track, more to be done in 2012

This week, the IMF-EC-ECB troika published a new version of the Memorandum of Understanding with Portugal that incorporates an evaluation of the steps taken so far by the Portuguese government.

EM flows to emerging market bonds remain resilient...

... but investors have adjusted growth expectations for EM equity funds.

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Markets

Interest Rates: ECB announces new dollar-denominated auctions

The ECB has announced that in conjunction with the Federal Reserve and other central banks it will carry out three dollar liquidity operations with a maturity of 3 months (12 October , 9 November and 7 December) in order to prevent funding stress in the currency through the rest of the year. These three auctions will be in addition to the weekly unlimited liquidity auctions that have been taking place since May 2010, when they were reintroduced in response to the start of the Greek crisis. These weekly auctions currently require collateral and are fixed-rate, like the one-week dollar OIS +100bp. The rate for the ECB's three months auctions will be similar.

This announcement from the ECB is clearly a response to the difficulties European banks are encountering in obtaining dollar-denominated funding:

1. Cross currency swaps have widened, reflecting the rise in cost of exchanging a euro swap for a dollar swap. As shown in the chart these swaps have been highly correlated with the spread between financial risk indicators in Europe and the US.
2. The volume of dollar-denominated commercial paper in circulation, issued by non-US entities (mainly from Europe) has dropped sharply in the last month, reflecting European banks' funding difficulties.
3. The rise in the 3M Libor (from 0.24% to 0.35%) is partially due to the fact that the increase in contributions from European banks (and especially French banks) was greater that in other Contributor Panel banks.

The immediate impact of this ECB measure should be a correction in cross currency swaps and Libor-OIS spread tightening (especially forwards).

Forex: Risk assets recovering on the back of the easing risk in the EU, but the

global forex market is still reflecting some risk aversion Over the last week, forex markets were highly volatile, fluctuating in response to news concerning the European Union. Although the week started with negative sentiment, support for Greece in Merkel and Sarkozy's statements, the stepping up of the austerity measures in Italy, the possibility of peripheral bonds being bought by China and the Ecofin meeting contributed to a decline in risk aversion and favoured a recovery in risk assets towards the end of the week. However, the forex market did not reflect this: CHF and JPY increased their gains vs. USD (appreciating on Thursday by 1.5% and 1.0% respectively), while EM currencies mostly depreciated (Asian currencies peformed relatively worse, but MXN and BRL also saw drops of around 2%). EUR benefited from the reduction in EU risk, while US economic data was not favourable. However, there are still risks, so we do not expect gains to continue, but rather consolidation in the short term, especially in the run-up to the Fed meeting this week.

Credit: Pressure on credit markets eases slightly

Following a black Monday on credit markets, with many synthetic indexes reaching their historical peaks, in the last two days sentiment has improved on credit markets, with marked spread tightening. However, despite this improvement, investors still seem to be cautious. We think that in the short-term credit valuations in Europe may continue to accumulate significant losses, despite the rebound of the last few days. At present, there is no evidence that the prices of corporate bonds have bottomed out, especially in view of the major uncertainties in Europe: i) the European sovereign crisis, which has been accentuated by slowing economic growth; ii) concerns over the Greek bailout; iii) difficult access to funding on the primary market.

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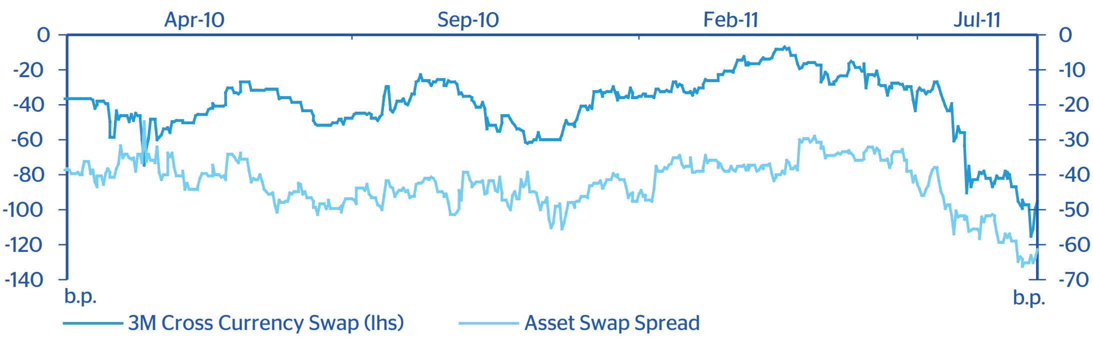
Chart 3
3M Cross Currency Swap vs. 2Y Europe-US Asset Swap Spread



Source: Bloomberg and BBVA Research

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Highlights

Funding strains to carry on until underlying concerns are addressed

Because of fears of potential stability problems caused by the negative feedback between sovereign debt and bank solvency, investors have not shown any interest in buying their commercial paper. As banks have not been able to borrow from markets, funding strains have risen further in EZ markets and more recently extended to funding in USD (EZ banks fund themselves partially with dollars). The ECB is attempting to ease the pressure on both fronts. The ECB was already providing unlimited liquidity to EZ banks (and recently reintroduced a 6m LTRO and will most likely extend both the MROs and LTROs for as long as needed) and this week announced – in conjunction with the Federal Reserve and central banks in Japan, Britain and Switzerland – additional 3-month US liquidity operations to provide the USD funding that cannot be raised in the markets. EZ funding remains concentrated in the most vulnerable countries, but banks from other peripheral countries (particularly Italian banks) have increased their dependency over the past three months. At the same time, the use of the deposit facility has risen sharply, showing that banks are again hoarding funds rather than lending to each other. This is another sign of liquidity stress but also shows the increase in ECB funding is in part a precautionary move by banks, possibly anticipating further deterioration in debt capital markets. This week's news is positive: they show the ECB's resolve to backstop EZ banks and marks a new beginning in global financial coordination. However, its positive effects could gradually fade as underlying concerns remain, lying in EZ sovereigns, and there is a perception that European policymakers thus far have followed a "band-aid" approach.

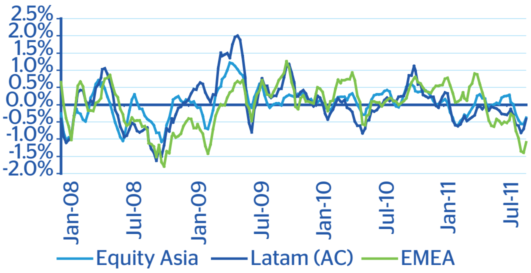
Portuguese adjustment programme on track, more to be done in 2012

This week, the IMF-EC-ECB troika published a new version of the Memorandum of Understanding with Portugal that incorporates an evaluation of the steps taken so far by the Portuguese government. There is a deviation of fiscal outcomes with respect to the target in 2011 (which the new government attributes to measures taken during the first half of the year) that implies a slippage of 1.5% of GDP. Several steps have been taken to fill the gap, including a temporary surcharge on income tax for this year (yielding 0.5% of GDP), bringing forward measures planned for 2012 (higher taxes for gas and electricity, 0.1%), sales of concessions (0.4%) and accelerating the plans to transfer assets from banks' pension funds to the state social security system (0.5%). These measures will fill the gap for 2011 and reflect the government's commitment to the target. However, they are all temporary by nature, or bring forward measures planned for 2012, which implies that in 2012 further adjustments will have to be made. The government is studying these new measures, amounting to 0.6% of GDP – although, according to our calculations, the additional adjustment will have to be bigger.

EM flows to emerging market bonds remain resilient

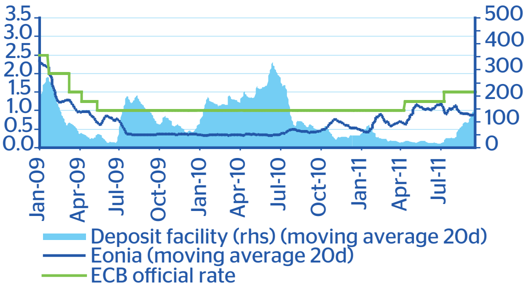
The downward adjustment on US growth expectations and the increasing uncertainties about the EZ sovereign debt crisis have paved the way for outflows from investment funds since the second week of August. In the recent risk aversion episode, outflows from bond investment funds were minimal (-0.13% monthly average) compared with the outflows registered after the Lehman bankruptcy crisis (-3%), while Equity funds have registered quite similar outflows to LB (-0.8% vs. -1.4% respectively). EMEA countries register higher outflows (-1.4%) follow by Latin American and Asian countries. We expect inflows to Asian markets to resume as growth remains resilient, while the return of inflows to Latin America would be more moderate than in Asia due to its exposure to the US cycle. In the case on Eastern Europe, its exposure to European financial strain could still weigh on inflows to the region.

Chart 4
Flows to emerging market equity investment funds



Source: EPFR

Chart 5
Official rate, Eonia and deposit facility



Source: Bloomberg and BBVA Research

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Calendar: Indicators

Eurozone: Flash PMI composite (September, September 22nd)

Forecast: 50.1	Consensus: 49.6	Previous: 50.7

Comment: we expect the composite PMI to decline slightly in September, as in August, after the sharp fall recorded by mid-year. The headline index should remain slightly above the 50 point threshold, suggesting that economic growth in the eurozone could be almost stagnant in Q3 after a modest 0.2% q/q in Q2. Nevertheless, the resurgence of the sovereign debt crisis and the lack of determination by the European authorities to solve it could have been felt in agents' sentiment, resulting in downside risks to our forecast. Across sectors, the manufacturing index should remain in contractionary territory, while sentiment in the service sector is expected to be broadly stable, pointing to a slight expansion. The declining trend is expected to be observed across member states, but while PMIs could indicate modest growth in core countries, peripheral economies could have moved into contractionary territory. **Market Impact:** a sharp drop in PMIs in core countries could signal a return to recession in the eurozone.

Eurozone: Industrial new orders (July, September 22nd)

Forecast: 0.5% m/m	Consensus: -1.2% m/m	Previous: -1.0% m/m

Comment: we expect industrial orders to have increased slightly in July after falling significantly in the previous month. Nevertheless, the downward trend observed in Q2 is likely to continue in coming quarters, partly reflecting the recent slowdown in global growth together with disappointing domestic demand observed in Q2. Confidence surveys also showed a similar picture, anticipating a very subdued outlook for the industrial sector. **Market impact:** a sharp decline in orders could be interpreted by markets as an increased likelihood that the industrial sector could contract again in coming quarters.

US: Existing Home Sales (August, September 21st)

Forecast: 4.55M	Consensus: 4.75M	Previous: 4.67M

Comment: existing home sales are expected to decline in August for the third consecutive month as demand conditions remain weak. The housing market outlook has deteriorated throughout the summer months, with low employment growth and weak consumer activity weighing on the economic recovery. Furthermore, tight credit conditions make it difficult for consumers to take advantage of extremely low interest rates. In general, it is unclear whether the recovery will strengthen in the coming months, and negative housing prospects are likely to prevail. **Market Impact:** the slowdown in economic activity is widely known, so minimal declines in existing home sales should warrant little reaction from markets. However, better-than-expected sales could indirectly stimulate economic activity and strengthen market confidence.

US: Jobless Claims (September 16, September 22nd)

Forecast: 420K	Consensus: 420K	Previous: 428K

Comment: initial jobless claims for the week ending September 16th are expected to show little improvement after weeks of disappointing reports. The employment situation remains discouraging, with no growth in non-farm payrolls and steady increases in initial claims since mid-August. Despite a holiday-shortened week, which often skews the numbers down, last week's figure was the highest since June. Furthermore, the four-week moving average was 15K higher compared to one month ago. Looking forward, we expect jobless claims to stay in line with the average at 420K. **Market Impact:** markets will watch closely for signs of job growth for September, however continued increases in initial claims will likely increase market anxiety.

Taiwan: export order (August, September 20th)

Forecast: 7.8% y/y	Consensus: 7.6% y/	Previous: 11.1% y/y

Comment: as a leading indicator of actual exports for the ensuing 1 to 3 months, Taiwan's export orders are a good gauge of global demand. Weakness in US and European growth is already having an impact on Taiwan's export performance, which is closely watched given the economy's position in the global supply chain. Nevertheless, robust demand from mainland China is proving to be a support for export demand, especially for information and communication products. **Market Impact:** a worse than expected outturn could undermine confidence in Asia's growth outlook, and solidify expectations that the rate hike cycle has ended.

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			Close	Weekly change	Monthly change	Annual change
Interest Rates (changes in bps)	US	3-month Libor rate	0.35	1	6	6
		2-yr yield	0.19	2	0	-27
		10-yr yield	2.11	19	-5	-63
	EMU	3-month Euribor rate	1.54	0	0	66
		2-yr yield	0.58	19	-12	-20
		10-yr yield	1.92	15	-29	-51
Exchange Rates (changes in %)	Europe	Dollar-Euro	1.381	0.9	-4.4	5.8
		Pound-Euro	0.87	1.3	0.2	4.6
		Swiss Franc-Euro	1.21	-0.1	5.9	-8.4
	America	Argentina (peso-dollar)	4.20	0.0	0.9	6.5
		Brazil (real-dollar)	1.71	2.0	8.0	-0.3
		Colombia (peso-dollar)	1817	1.0	2.7	0.7
		Chile (peso-dollar)	478	1.9	2.5	-4.0
		Mexico (peso-dollar)	12.91	2.2	6.1	1.1
		Peru (Nuevo sol-dollar)	2.73	0.2	-0.4	-2.1
	Asia	Japan (Yen-Dollar)	76.83	-0.7	0.4	-10.4
		Korea (KRW-Dollar)	1112.40	2.7	4.1	-4.2
		Australia (AUD-Dollar)	1.038	-0.7	-1.4	10.7
Comm. (chg %)		Brent oil ($/b)	113.8	0.9	2.9	45.5
		Gold ($/ounce)	1789.6	-3.6	-0.1	40.4
		Base metals	568.5	-0.9	-0.3	9.2
Stock Markets (changes in %)	Euro	Ibex 35	8438	6.7	-3.3	-20.3
		EuroStoxx 50	2190	5.6	-6.1	-20.6
	America	USA (S&P 500)	1218	5.5	2.0	8.2
		Argentina (Merval)	2771	0.7	-7.4	12.0
		Brazil (Bovespa)	56868	2.0	3.3	-15.2
		Colombia (IGBC)	13684	2.0	1.6	-2.6
		Chile (IGPA)	19561	-0.8	-3.4	-13.1
		Mexico (CPI)	35181	4.0	3.3	6.5
		Peru (General Lima)	20422	2.6	2.2	22.1
		Venezuela (IBC)	100760	1.0	2.6	54.6
	Asia	Nikkei225	8864	1.4	-2.1	-7.9
		HSI	19455	-2.1	-4.1	-11.4
Credit (changes in bps)	Ind.	Itraxx Main	174	-15	32	67
		Itraxx Xover	715	-47	118	244
	Sovereign risk	CDS Germany	83	-1	8	42
		CDS Portugal	1061	-75	208	696
		CDS Spain	374	-39	43	138
		CDS USA	50	0	1	---
		CDS Emerging	298	-10	42	57
		CDS Argentina	869	30	120	99
		CDS Brazil	164	-4	26	46
		CDS Colombia	164	-4	30	38
		CDS Chile	116	10	21	43
		CDS Mexico	163	-2	26	35
		CDS Peru	169	-1	25	38

Source: Bloomberg and Datastream

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