BBVA Research

Global

Weekly Watch

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Economic Analysis

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Loose DM monetary policy in 2011

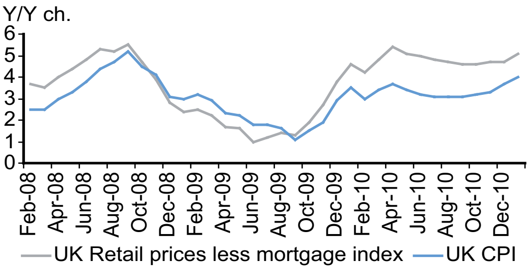
The latest inflation data confirm the short-term inflation pressures. Nonetheless, what matters to central banks is the medium-term outlook and there are no signs of deterioration. In other words, as long as inflation expectations remain well-anchored, central banks in DM can maintain their loose monetary policies for longer, as second-round effects on inflation are small. The UK CPI rose to 4% y/y in January. Moreover the BoE inflation report also showed that inflation remains in uncomfortable territory, rising to levels between 4% and 5% by the middle of the year before falling back to about 1.7% in 2013. In the US CPI rose to 1.6% y/y. Furthermore, the issue of a pass-through of higher commodity prices was raised during the last FOMC meeting, but most members consider the impact to be minimal. At the same time, FOMC minutes revealed cautious optimism about economic recovery. Minutes noted an uptick in consumer spending and the Fed raised the lower end of its growth forecast range. All in all, market participants continue to bring forward rate increase expectations in developed markets (DM). The implicit probability of a Fed rate first move in Dec 2011 is now above 80%, while two 25bps rate hikes are now anticipated for the ECB by year-end. This seems too early to us.

Positive growth surprises in Peripherals

4Q GDP growth was better than expected in Spain and Portugal. GDP figures reflected the negative impact of fiscal consolidation, but this was partially offset by higher external demand growth and the better-than-expected behaviour of private demand. Portugal's debt buy-back ended with a low offering, signalling that investors are not worried about short-term maturities. Despite this positive news, sovereign risk has not retreated. Investors knew that the increase in the lending capacity of the EFSM or EFSF would be subject to strict conditions, so we would not expect any improvement in sovereign risk before the conclusion of the EU Council meetings on 11th and 25th of March. In addition, the German position regarding Governance could be tougher with Weber out of the race for ECB presidency. Emerging countries have shown the first signs of slowdown in their economic trend due to the impact of tighter monetary policy, especially in China and Brazil. Therefore economic indicators in EM are coming into line with our soft-landing scenario.

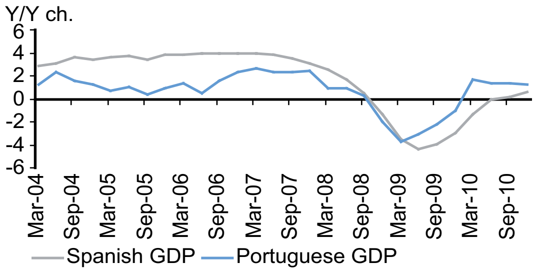
Next week the market will be focused on economic activity in the Eurozone which could continue showing strong momentum. We do not consider that G-20 will end with strong proposals to reduce global imbalances or will establish a new currency reserve while pressures for renminbi appreciation will remain.

Chart 1
UK Inflation Trend



Source: BBVA Research

Chart 2
EU Peripherals' GDP Growth



Source: BBVA Research

Highlights

Policy rate increases can wait until 2012

We expect the ECB to make the first move before the Fed.

Focus on ECB liquidity

ECB provision of liquidity remains at high levels.

China's inflation outturn helps to ease market concerns

Inflation was below market expectations, but underlying pressure remains.

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Markets

Less upward impetus at the long ends of curves

In recent days interest rates in OECD curves have eased somewhat and even dropped, especially the long ends of curves: while the 10Y euro swap has dropped by around 13bps from its 9 February highs, the 10Y dollar swap has fallen 15bps. It is significant that this profile has materialized during a phase in which cyclical indicators have not been particularly disappointing, and above all price indexes have continued to reflect the impact from commodities (US CPI up by around 0.4%). This smaller upward reaction at the long end of curves confirms that to some extent the market may have already almost fully adjusted to a scenario of slightly more price risk in the medium term, but also that this risk is not a pressing issue at present. In fact, inflation breakevens in the US curve have dropped by around 15bps in recent days, reflecting some reluctance on the market to continue pushing up expected inflation. This outlook reinforces our expectation that curves should consolidate the levels they reached following the adjustment in late 2010-early 2011, but without enough steam to continue aggressively with it.

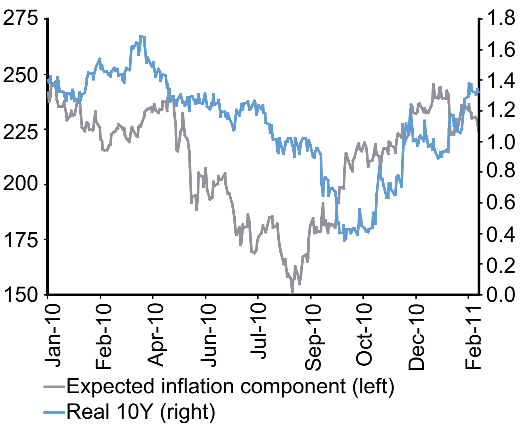
Flows are giving the orders and signal the direction for equity

From the end of November to date the EuroStoxx-50 has risen by around 15%, favoured by easing sovereign risk in Europe, which has result in high volumes of investment flows into Spanish equity, and consolidation of the improved growth forecasts for the Eurozone. Since expected earnings have hardly moved during this period, and as the 10-year bond has tightened by 50bps, there has been a marked reduction in the apparent equity risk premium. The problem is that the risk premium is the most volatile of the variables that determine the value of an asset, so we must remain cautious with regard to the sustainability of this trend. This has translated into, for example, the banking sector clearing leading the rally (which adds consistency and sustainability to it), also favouring a significant reduction in implied volatility, as measured by the V2X.

The current window for issuance on the primary market remains opened

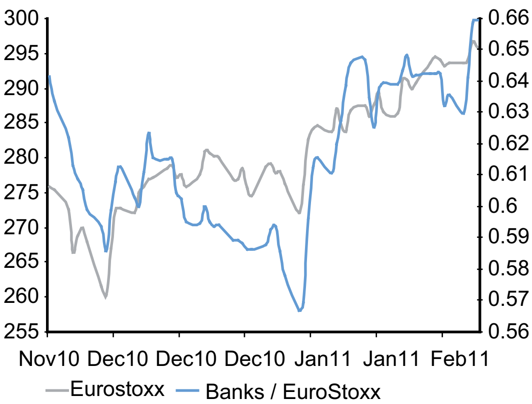
Covered bonds have continued to play the starring role, with EUR20bn issued so far this month. French, German, Italian and Spanish issuers have been the most active. Also, the FADE (Tariff Deficit Securitization Fund) issued EUR2bn of 4-year debt at ms+234, 53% of which went to Spanish investors, in its second issuance of 2011. In general, all issuers had high bid-to-cover ratios, against a backdrop of high liquidity which we do not consider to be subject to sufficient risk in the short term to close the current window for issuance on the primary market.

Chart 3
US 10Y Govt Rates: Real Rates vs Expected Inflation Component



Source: Bloomberg

Chart 4
Eurostoxx vs. Banks



Source: Bloomberg

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Highlights

Policy rate increases can wait until 2012

We're bringing forward the first move by both the Fed (to June 2012) and the ECB (to April 2012). We now expect the ECB to make the first move of a gradual tightening path before the Fed, as the ECB gradually tries to fully focus on its inflation mandate. In both cases, two reasons stand out among others: 1) the output gap might be more contained and closing more rapidly. In the US, the output gap is shrinking faster and we now expect a faster recovery. In Europe, the economic outlook is somewhat better, capacity utilization is near to its long-run average and showing signs of improvement, and the ECB believes that the gap is contained; and 2) Risks (i.e. the probability of the "tail risk" scenario) have diminished significantly. In the US, deflationary pressures have receded markedly while sovereign risks in peripheral Europe are decreasing and a favourable resolution seems more probable. Our estimated "reaction functions" signal that both the Fed and the ECB might consider raising their policy rates relatively soon (in 1Q12 and possibly earlier in the case of the ECB) but we think there are several reasons why they will not hike rates so early and maintain their respective loose monetary policy stances for longer. The Fed will remain uncomfortable with the high unemployment rate (UR) which they believe is mainly the result of cyclical factors and thus, monetary policy still can play a significant role in reducing it. Meanwhile, the ECB might prefer to wait for longer as 1) although the probability of "tail risks" has diminished, there are still many unresolved issues in the periphery and any action in the short-term could potentially be de-stabilising; 2) inflation expectations remain anchored and wages subdued; and 3) M3 and credit remain flat; and 4) they might not wish to increase rates much sooner than the Fed.

Focus on ECB liquidity

The latest data released on ECB borrowing referring to January showed a decrease in some financial systems, including Spain, which has experienced a sizeable improvement. Specifically, Spanish banks' borrowing from the ECB fell to EUR53bn in January, down by 20% to its lowest level since October 2008. This decline is due to several factors: 1) the fact that financial tensions have eased since mid-January which has been reflected in a partial reopening of the primary market, 2) the repo markets continue functioning well through clearing houses and 3) interbank markets continue to improve, although some of these funding options are still not accessible to the smallest, more vulnerable Spanish financial entities. However, as a whole ECB provision of liquidity remains at high levels and continues to be concentrated in the most vulnerable banks. In particular, the banking systems of Greece, Portugal and Ireland represent nearly 9% of the total banking system in the euro area (by assets) but account for around 50% of ECB borrowing. In this context the ECB is worried about supporting weak institutions and delaying restructuring, as "this addiction should be progressively be eliminated". At the same time it is recognized that this is not an isolated problem and also that "an abrupt withdrawal of the liquidity measures could cause excessive or too rapid adjustments by financial institutions". In the March ECB meeting an extension of the full-allotment is likely to be announced but it should always be taken into account that the ECB has stressed, in recent meetings, its emphasis on the "separation principle" between monetary policy and non-standard measures.

China's inflation outturn helps to ease market concerns

A number of indicators released this past week in China helped to ease market concerns of a hard landing. In particular, January CPI inflation came in at 4.9% y/y, consistent with our expectations, but well below the market consensus (BBVA: 4.9% y/y; consensus: 5.4% y/y). Sceptics noted that the inflation reading is based on new official weights in the calculation of the CPI, in which food and other components are given a lower weight, while housing costs are given a higher weight. However, the new weights appear to have had a negligible impact on the outturn. That said, inflationary pressures remain high, with food prices and housing costs rising in January by 10.3% y/y and 6.7% y/y, respectively, and producer prices up by 6.6% y/y (consensus: 5.9%). Another piece of good news was a relatively benign outturn for new loans in January, of RMB 1.04 trillion (consensus: RMB 1.20 trillion), 25% below the level in the same period last year. Together with a soft reading for M2 growth, the outturn suggests the authorities' tightening measures may be more effective so far than was expected by the market. Nevertheless, further efforts to prevent overheating will still be needed, as the inflation and M2 growth outturns remain well above the authorities' comfort levels. Separately, property prices continued to rise in January, at 6.4% y/y. Consequently, we do not anticipate a change in the authorities' monetary tightening campaign, with our expectations remaining for two additional rate hikes of 25bps in Q2/Q3, along with at least 50bps of additional hikes in reserve requirements (RRR), besides the hike in RRR announced today.

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Calendar: Indicators

Eurozone: Economic Sentiment Indicator (February, February 24th)

Forecast: 106.7	**Consensus:** 106.8	**Previous:** 106.5

Comment: : Economic sentiment in the Eurozone is expected to remain broadly stable in February, increasing only marginally after the improvement in consumer confidence. Industry sentiment could improve further, supported by robust global demand, but offset by the slight decline expected for service confidence. Overall, these figures suggest that economic growth could have gathered pace at the beginning of this year. In addition, we expect confidence from th PMI survey to also remain stable, but at higher levels than those observed in Q4. **Market Impact:** A sharper decline in confidence data could negatively affect markets, after lower than expected GDP for Q4.

Eurozone: M3 (January, February 25th)

Forecast: 2.0% y/y	**Consensus:** 1.9% y/y	**Previous:** 1.7% y/y

Comment: Eurozone lending data for January are expected to reflect further evidence of the weakness of credit aggregates, without signs of a clear recovery. In particular, M3 is expected to have increased slightly over the previous month, resulting in a higher year-on-year rate at around 2%. Across its counterparts, loans to households are projected to have grown at similar rates to those seen over the last year (around 0.3% m/m), while those to non-financial corporations could have declined further, as observed in the previous month, with annual rates still remaining in negative territory. **Market impact:** Better than expected outcomes could be received as a sign that credit is finally recovering, but could also be interpreted as a sign of earlier ECB hikes.

US: Case-Shiller 20-city Index (December, February 24th)

Forecast: -1.78% y/y	**Consensus:** -2.3% y/y	**Previous:** -1.59% y/y

Comment: Housing prices in December will decline slightly and remain below those of last year, indicating a year-over-year change of -1.8%. As demand for homes is strengthening and inventories are shrinking, home prices will stabilize further in coming months. Positive employment growth, increasing family income and low mortgage rates will continue to stimulate demand. However, the housing market remains weak and there is some uncertainty, as the current high number of foreclosures and limited access to credit will limit house price appreciation in 2011. **Market Impact:** An increase in home prices would imply stronger-than-expected residential markets and increase optimism in the financial markets.

US: Existing Home Sales (January, February 23rd)

Forecast: 5.35M	**Consensus:** 5.20M	**Previous:** 5.28M

Comment: Existing home sales are expected to increase in January, as indicated by the 2% increase in pending home sales. Market conditions continue to favour the buyer as home prices and mortgage rates are low and affordability levels are high. Looking at historical data, the inventory to sales ratio for existing homes (the number of months required to sell the existing inventory) for the past few months has decreased from 10.5 to 8.1 months. Market conditions continue to favour the buyer as home prices and mortgage rates are low and affordability levels are high. These conditions will help to support home sales moving forward. **Market Impact:** Existing home sales have increased over the previous two months and if the sales in January turn out as we expect, it would surprise the markets positively.

Singapore: CPI inflation (January, February 23rd)

Forecast: 3.9% y/y	**Consensus:** 4.4% y/y	**Previous:** 4.6% y/y

Comment: : Inflation continues to rise in Singapore, driven by higher transport costs and housing prices. While underlying pressures remain strong, we expect monthly inflation to decline following an exceptionally large increase in December. Our end-year inflation projection is 3.6%, and the Singapore trade ministry has just raised its inflation forecast for 2011 from the previous 2%-3% to 3%-4%, warning that inflation may rise to 5%-6% in the coming months and underscoring the authorities' challenge to tame inflation. **Market impact:** A higher-than-expected inflation reading would raise expectations of further monetary tightening through faster currency appreciation. The Monetary Authority's next policy meeting is in April.

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				Close	Weekly change	Monthly change	Annual change
Interest Rates	(changes in bps)	US	3-month Libor rate	0.31	0	1	6
			2-yr yield	0.79	-5	22	-13
			10-yr yield	3.60	-2	27	-17
		EMU	3-month Euribor rate	1.08	-1	6	42
			2-yr yield	1.38	-3	22	30
			10-yr yield	3.23	-7	12	-6
Exchange Rates	(changes in %)	Europe	Dollar-Euro	1.361	0.7	1.0	0.3
			Pound-Euro	0.84	-0.7	-0.5	-4.4
			Swiss Franc-Euro	1.29	-1.9	0.4	-11.7
		America	Argentina (peso-dollar)	4.02	0.0	0.9	4.2
			Brazil (real-dollar)	1.67	0.1	-0.3	-7.4
			Colombia (peso-dollar)	1879	-0.3	2.1	-2.9
			Chile (peso-dollar)	470	-0.6	-4.6	-11.7
			Mexico (peso-dollar)	12.03	-0.3	-0.5	-6.1
			Peru (Nuevo sol-dollar)	2.77	0.1	-0.3	-3.0
		Asia	Japan (Yen-Dollar)	83.27	-0.3	1.6	-9.4
			Korea (KRW-Dollar)	1111.33	-1.1	-0.3	-3.7
			Australia (AUD-Dollar)	1.012	1.2	1.0	12.8
Comm.	(chg %)		Brent oil ($/b)	100.9	-0.6	2.8	29.0
			Gold ($/ounce)	1386.1	2.1	1.2	23.9
			Base metals	621.4	0.8	4.5	28.4
Stock Markets	(changes in %)	Euro	Ibex 35	11002	1.8	4.2	3.0
			EuroStoxx 50	3061	1.2	4.7	9.6
		America	USA (S&P 500)	1340	0.8	4.5	20.8
			Argentina (Merval)	3539	2.3	-2.7	51.5
			Brazil (Bovespa)	67854	3.2	-3.1	0.4
			Colombia (IGBC)	14311	-0.9	-4.3	23.5
			Chile (IGPA)	21399	-1.8	-7.5	20.1
			Mexico (CPI)	37226	0.6	-1.5	15.7
			Peru (General Lima)	22789	0.1	3.0	57.7
			Venezuela (IBC)	66551	0.4	1.2	17.2
		Asia	Nikkei225	10843	2.2	2.7	7.1
			HSI	23595	3.4	-3.4	18.6
Credit	(changes in bps)	Ind.	Itraxx Main	96	-1	-7	9
			Itraxx Xover	384	-16	-27	-83
		Sovereign risk	CDS Germany	53	-1	-5	10
			CDS Portugal	453	11	-14	291
			CDS Spain	250	8	-33	133
			CDS USA	47	0	-3	---
			CDS Emerging	218	-3	16	-56
			CDS Argentina	627	3	92	-483
			CDS Brazil	115	-7	6	-16
			CDS Colombia	117	-7	7	-42
			CDS Chile	78	-6	-3	1
			CDS Mexico	114	-8	1	-17
			CDS Peru	112	-8	3	-22

Source: Bloomberg and Datastream

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