

Global

Weekly Watch

Madrid, 18 March 2011

Economic Analysis

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Coordinated efforts

The devastating earthquake and tsunami that has struck Japan has increased financial markets' uncertainty, reducing appetite for risky assets. The cost in terms of human lives and damage is likely to be greater than the real impact on the Japanese GDP, as long as there is no nuclear contamination (see highlight). G-7 countries have agreed to coordinate currency intervention to prevent excessive appreciation of the yen. In our view, the negative market impact should fade away in coming weeks as long as the nuclear threat does not become a reality. Looking forward, geopolitical risk due to the unrest in MENA countries could be back in the spotlight.

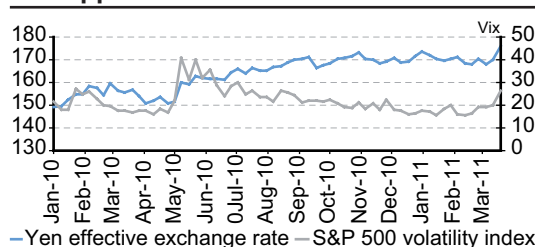
In spite of the concerns arising from recent developments, emerging Central Banks are continuing to raise policy rates – Colombia, Chile and India increased rates this week – as part of a gradual return to neutral rates. However, although the Fed is in no hurry to raise rates, the policy statement was slightly less dovish than expected, upgrading the assessment of growth and pointing out that core inflation is no longer trending downward. Meanwhile, headline inflation continues trending upwards in both the US and the Eurozone, while US core inflation was higher than expected, adding to the evidence that it is likely to have bottomed.

Risk in the European periphery has diminished

The agreement reached at the last European Council meeting on March 11 was a positive surprise, but mostly since initial expectations were very low. The council has improved the liquidity facilities for the periphery of Europe, making them conditional of reforms in these countries in order to minimize the risk of debt restructuring. In particular, the council agreed to expand the EFSF's lending capacity to €440bn from €250bn, to set the lending capacity of the future ESM at €500bn and to allow the EFSF to purchase bonds in primary markets (but not in secondary markets, as was requested by many, including the ECB). It has also lowered the interest charged on rescue loans to Greece. Furthermore the EcoFin agreement contains a move toward more stringent fines and introduces a procedure to detect and address macro imbalances. All in all, the EU is moving towards stricter checks of fiscal discipline, more conditionality and to less doubt about emergency liquidity, but doubts on eventual restructuring remain, as this issue has not been directly addressed. Next week another key Council summit will take place (24-25 March), where we expect a possible improvement of Irish loan conditions, and where the crisis management mechanism will be addressed. We think most of the work was already done on March 11. Spain could present new proposal at the meeting.

Chart 1

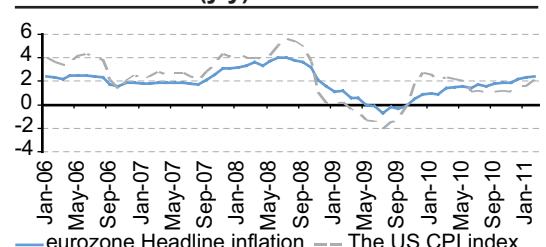
Yen Appreciation Pressures



Source: BBVA Research

Chart 2

Inflation Trend (y/y)



Source: BBVA Research

Markets



Highlights



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Highlights

Assessing the economic impact of the Earthquake in Japan

Although it has been devastating in terms of the death toll and damage, the economic fallout should be limited.

Portugal needs to approve announced measures...

...to convince eurozone partners that serious steps are being taken.

Evaluation of the macro scenarios for European banks stress test

The Spanish scenario is stricter than that of its peers.

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USDJPY smashes previous 1995 low of 79.75 and the G7 intervenes

This past week has been traumatic for the Japanese people and global markets. We remain concerned about Japan's citizens and its near-term economic outlook given the earthquake, ensuing tsunami and nuclear issues. The result of the disaster in Japan has seen a large repatriation of funds and market speculation funds will need to be repatriated from abroad over the short-term. USDJPY had been trending lower throughout the week, but after Wednesday's Americas close, preceded to decline by circa 3.5% to fresh all-time lows around 76.50 before bouncing back. Importantly, the move was a result of a severe lack of liquidity between the Americas and Asia sessions, coupled with barriers getting taken out around the 1995 lows, stop-losses subsequently getting triggered and a large repatriation of retail FX flows back into Japan (retail FX in Japan is quite large). While we had been suggesting there would not be intervention so long as USDJPY remained above 80, when the pair started trading in the 70s, the G-7 agreed to intervene, thus meaning that Japan would not have to go-it-alone.

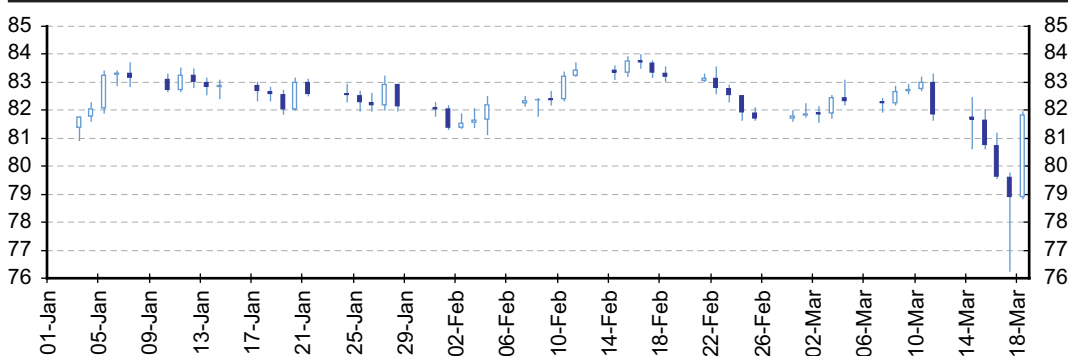
In equity, pay close attention to earnings estimates

In recent days there have been significant drops in the main equity indexes led by Energy, Basic Resources, Technology and Industrials. The catalyst? Japan, without a doubt, but the situation in Maghreb and the Middle East and the prior expectations of rate hikes were also factors. While markets deliberate over the impact of these events on economic growth, we think we are going to see a deterioration in earnings momentum, at least until 1Q11 earnings are published in Asia, the US and Europe.

Debt: European periphery, energy and short ends at the centre of movements

The agreements reached at the latest meeting of heads of state on 11 March more than exceeded the market's expectations, and the downgrade of Portugal's rating has only accentuated the decoupling between the performance of Spanish and Portuguese debt. Meanwhile, growing concerns over the damage to the nuclear plants in Japan have led to significant widening of both the Japanese CDS and those of European utilities with higher exposure to nuclear power. Finally, in recent days the safe haven effect has shifted to the short terms and the monetary curve. The correction places short-term rates at lower levels than prior to the last ECB meeting. This may be a reflection of some nervousness and uncertainty over the first hike in April, but we are still expecting it to happen. In our view, if the ECB were to decide on a postponement, it would announce it to the market in advance (something it has not done), as it did with regard to the preparations for the hike.

Chart 3
Yen/Dollar Intraday Performance



Source: Bloomberg

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Assessing the economic impact of the Earthquake in Japan

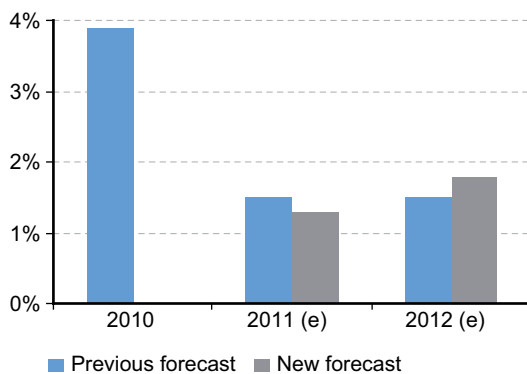
Japan is coping with the aftermath of the 9.0 magnitude earthquake on March 11 in the northeast, which was followed by a destructive tsunami. The loss of life and damage to property have been massive, with a death toll now surpassing five thousand, and the direct loss of infrastructure accounting for 3% of GDP. The hardest-hit region accounts for around 7% of Japan's national GDP, and is an agricultural base and auto making centre. Though estimates are still highly uncertain, we expect the overall economic impact to be modest. GDP growth in 2011 is likely to be 0.2pp lower than our baseline of 1.5%. However, reconstruction spending is likely to lift GDP growth by 0.3pp in 2012 (Chart 5). In the meantime, inflation will be pushed up temporarily as supply is reduced.

On the fiscal front, the extra budget spending for relief work will worsen Japan's fiscal position. The government will have to postpone fiscal consolidation plans, which had previously been given a priority due to Japan's high public debt ratio (around 200% of GDP on a gross basis). A key source of uncertainty is the risk of a nuclear disaster, which has increased fears and generated volatility in financial markets (the Japanese stock market is down by 11% so far). The yen briefly surged to almost 76 yen per USD on Thursday as the repatriation of capital after quake adds appreciation pressure; however, the appreciation should be temporary as the government is taking coordinated action with other G7 central banks to stabilize it.

The economic impact on other Asian economies at this stage is expected to be limited. Some countries may see an increase in exports to Japan as the reconstruction gets underway, to meet Japan's energy needs in the event of a prolonged closure of nuclear facilities, or to fill a temporary void in international markets. On the other hand, a negative impact could emerge through disruptions to supply chains and/or investment flows from Japan. The sharp sell-off in regional stock markets is a reminder of the uncertainties.

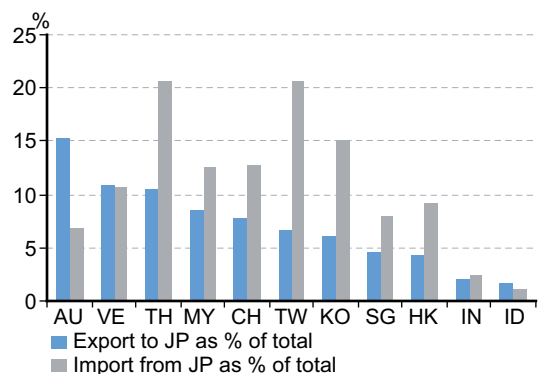
Beyond the region, some US treasury selling might occur, but it would be short-lived. Crude oil prices will face downward pressure in the short run from lower demand due to refinery outages and lower activity, but should rebound in the medium term as activity rebounds and the supply of nuclear-based electricity in the country is substituted with hydrocarbons.

Chart 4
Japan: GDP Growth



Source: BBVA Research

Chart 5
Asian Countries Trade Exposure to Japan as of 2010



Source: CEIC, Haver Analytics, and BBVA Research

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Portugal in need to approve the annouced measures

Last week, Portugal announced additional fiscal consolidation measures for this year, equivalent to 0.8% of GDP. The government did not change its deficit target, but the new measures mean it is more likely to achieve the current one (4.6%) even if something goes wrong. In addition, it announced specific measures to achieve its 2012-13 objectives, which had been set at 3% and 2% of GDP but which were not backed by enough concrete measures until now. Together with fiscal action, there are also moves to define structural reforms – a vital issue for Portugal, whose problems are primarily a lack of productivity and growth, rather than purely fiscal problems, as its deficit and debt levels are clearly below other periphery countries.

The announced measures are comprehensive and look bold enough to convince Eurozone partners that serious steps are being taken. However, the problem is now twofold: on one hand, the government has no majority to approve reforms on its own, while the centre-right opposition party has said that it does not support the package, arguing that the adjustment is too tight. On the other hand, spreads are still too high, and it is clear that many market participants do not trust growth prospects and are convinced Portugal needs a bailout.

Two scenarios appear possible in the short run: either Portugal manages to approve the new measures quickly and present them at the summit next week, receiving some backing from its euro partners – possibly in the form of a commitment to purchasing Portuguese bonds in the primary market, leading the way for some relaxation in its spreads; or it does not, and in that case asking for EFSF money would be a done deal, before or after early elections. Both major parties probably want to avoid the task of going to elections at this point, so the first scenario seems more likely for the immediate future.

Evaluation of the macro scenarios for European banks stress test

The European Banking Authority (EBA) has published today the macroeconomic scenarios and the methodology of 2011 stress test. Assumptions are in line with market expectations and similar to 2010 exercise: soft European scenarios will not increase the credibility ex-ante of the tests. However, once again the Spanish scenario is stricter than that of its peers.

On the one hand, the exercise is stricter than that of last year as it uses as reference core capital, and not tier 1 capital. However, the concrete definition of core capital and its minimum level has not been disclosed. On the other hand, the exercise is soft as it does not stress according to market risk the available for sale and banking book fixed income portfolios. This fact could penalize Spanish institutions, which have not reclassified trading book assets into these portfolios as much as its European peers.

The exercise will be carried out in March-April, on April 13th banks will have to provide their national regulators with the information requested and the final publication of the stress test is due in June after an extensive peer review.

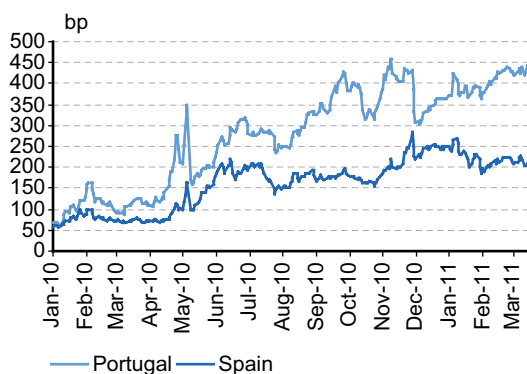
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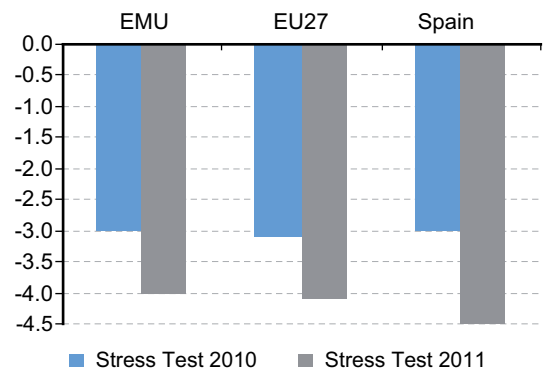
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Chart 6
The 10Y government yield Spread vs German Bond



Source: Bloomberg

Chart 7
Accumulated Fall in GDP after Two Years (Deviation from Baseline Scenario %)



Source: BBVA Research

Economic Analysis

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Calendar: Indicators

Eurozone: PMI Composite (March, March 24th)

Forecast: 57.8	Consensus: 58.4	Previous: 58.2
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Comment: The PMI composite is expected to decline in March, after the rebound observed at the beginning of the year, due to a negative impact on economic sentiment from both the interest rate hike announced by the ECB and the disaster in Japan. This would imply increased uncertainty over the economic outlook for coming months. Despite this expected decline, these figures continue to suggest that the recovery is gathering pace in Q1. Across components, we see a stronger decline in industry sentiment, while service confidence should have remained more resilient. **Market Impact:** A strong decline in PMI data could negatively affect markets, as a deterioration of confidence could weigh on the recovery in the coming months.

Eurozone: M3 (February, March 25th)

Forecast: 1.6% y/y	Consensus: 1.7 % y/y	Previous: 1.5% y/y
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Comment: Eurozone lending data for January are expected to reflect a still sluggish credit performance. M3 is projected to be virtually flat in February, interrupting the declining pace observed in recent months. Across its counterparts, loans to households are expected to have increased further, accelerating from growth rates observed over the last year. Nevertheless, loans to non-financial corporations could have remained flat, after the significant rebound observed in January. **Market impact:** Better than expected outcomes could be seen as a sign that credit is finally recovering, but could also be read as a trigger of a tighter stance by the ECB.

US: Initial Jobless Claims (March 19th, March 24th)

Forecast: 375K	Consensus: 383K	Previous: 385K
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Comment: Labour market conditions are improving gradually. In the last three months, the unemployment rate dropped by 0.9 basis points from 9.8% to 8.9% and the private sector created 222K new jobs in February. As a result, applications for jobless insurance claims have been declining. In particular, the latest 4-week initial jobless claims indicate that 386K people applied for jobless claims in the week ending March 11 which is the lowest level since July 2008. We expect the gradual improvement in labour markets to continue and therefore anticipate a slight decline in both initial and continuing jobless claims this week. **Market impact:** If initial jobless claims drop below 365K, this would imply a significant improvement in labour market conditions and increase optimism in the financial markets.

US: Durable Goods Orders (February, March 24th)

Forecast: 0.5% m/m	Consensus: 1.0% m/m	Previous: 3.2% m/m
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Comment: In January, new orders in durable goods jumped 3.2% m/m, following three months of decline. However, when transportation equipment (which includes non-defence airplanes) is excluded, new orders declined 3.0%. New orders for non-defence aircraft and parts soared 5.137% m/m, so most of the increase in durable goods orders in January came from volatile non-defence aircraft and parts. We expect new orders in durable goods to continue increasing in February but at a slower pace. **Market impact:** Stronger-than-expected durable goods orders would point to stronger economic activity in the months ahead and, would therefore positively affect financial markets

Singapore: CPI inflation (February, March 23th)

Forecast: 5.7% y/y	Consensus: 5.2% y/y	Previous: 5.5% y/y
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Comment: After surprising significantly on the upside last month, inflation is expected to remain high in Singapore due to rising international oil prices, transportation costs and housing rent. Demand pressures are increasingly evident. **Market impact:** A higher-than-expected inflation reading could increase expectations that the Monetary Authority of Singapore will accelerate the pace of currency appreciation at its next 6-monthly policy meeting in April.

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Markets Data

			Close	Weekly change	Monthly change	Annual change
Interest Rates (changes in bps)	US	3-month Libor rate	0.31	0	0	3
		2-yr yield	0.58	-6	-24	-40
		10-yr yield	3.27	-13	-35	-42
	EMU	3-month Euribor rate	1.17	0	8	53
		2-yr yield	1.61	-4	23	61
		10-yr yield	3.18	-3	-5	7
Exchange Rates (changes in %)	Europe	Dollar-Euro	1.413	1.8	4.3	4.4
		Pound-Euro	0.87	1.2	3.6	-3.0
		Swiss Franc-Euro	1.28	-0.9	-1.9	-11.0
	America	Argentina (peso-dollar)	4.04	0.3	0.4	4.5
		Brazil (real-dollar)	1.67	0.6	0.2	-6.8
		Colombia (peso-dollar)	1874	0.2	-1.9	-1.8
		Chile (peso-dollar)	483	0.8	1.8	-8.7
		Mexico (peso-dollar)	12.05	1.0	-0.4	-4.2
		Peru (Nuevo sol-dollar)	2.76	-0.1	-0.1	-2.5
	Asia	Japan (Yen-Dollar)	81.18	-0.9	-3.0	-10.1
		Korea (KRW-Dollar)	1126.65	0.1	0.8	-0.7
		Australia (AUD-Dollar)	0.993	-1.9	-0.6	8.4
Comm. (chg %)		Brent oil (\$/b)	114.6	0.7	10.4	43.5
		Gold (\$/ounce)	1419.5	0.1	3.3	28.2
		Base metals	606.1	-1.1	-2.5	20.1
Stock Markets (changes in %)	Euro	Ibex 35	10350	-0.5	-6.3	-5.8
		EuroStoxx 50	2804	-2.8	-8.4	-3.2
		USA (S&P 500)	1285	-1.4	-3.8	10.8
	America	Argentina (Merval)	3291	-3.3	-7.2	38.2
		Brazil (Bovespa)	67232	0.8	-0.5	-2.3
		Colombia (IGBC)	14526	-0.1	0.3	21.9
		Chile (IGPA)	20683	-0.2	-4.5	17.3
		Mexico (CPI)	35668	-1.2	-3.8	8.0
		Peru (General Lima)	20790	-4.6	-8.8	41.1
		Venezuela (IBC)	69875	2.9	5.0	24.0
	Asia	Nikkei225	9207	-10.2	-14.8	-14.9
HSI		22300	-4.1	-3.7	4.3	
Credit (changes in bps)	Ind.	Itraxx Main	102	-1	6	24
		Itraxx Xover	404	7	11	-23
	Sovereign risk	CDS Germany	45	-3	-8	16
		CDS Portugal	542	27	89	414
		CDS Spain	223	-34	-26	115
		CDS USA	43	-1	-4	---
		CDS Emerging	222	9	1	4
		CDS Argentina	658	28	16	-260
		CDS Brazil	118	4	1	-2
		CDS Colombia	119	4	-1	-23
		CDS Chile	71	3	-9	-7
		CDS Mexico	113	5	-3	5
CDS Peru	121	5	8	3		

Source: Bloomberg and Datastream

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