BBVA RESEARCH

Weekly Watch

Global

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Economic Analysis

Financial Scenarios
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European Crisis spread to core countries

- **Financial strains are spreading to all Eurozone countries excluded Germany**
  European sovereign crisis woe has continued escalating. The poor demand at all European governments' debt auctions this week suggested that the lack of confidence is spreading to all Eurozone countries, with the exception of Germany. Moreover, Fitch rating agency has warned further contagion from Europe's debt crisis will pose a risk to American banks. The new Italian governments of "technicians" did not calm risk premium. This situation may force new steps to stop contagion as soon as possible. Apart from higher compromise from European politicians to implement the expected structural reforms or fiscal consolidation actions, a higher ECB roll is also required. Nevertheless, up to now Germany and the ECB are still reluctant to take a step in this direction.

- **Positive economic data in US failed to provide support**
  Over this week US economic reports have shown improvement on real indicators. The US industrial production rose surprised positively in October, easing fears of a global slowdown. Additionally, US retail sales rise broadly in October. Finally US Jobless claims continued below 400k. Nevertheless, Philadelphia FED leading indicator for November brought some concerns on the sustainability of the ascendant movement registered by previous data. On the other hand, European GDP was mildly positive in Q3 (0.2% q/q and 1.4% y/y), but heading for negative figures at the end of the year. There were a small positive surprise in Germany, a rebound in activity in France, and below average growth in the periphery. Nevertheless, European industrial activity decreased in September for the first time in Q3, and might continue deteriorating in the near future, as PMI surveys already indicated earlier this month. The peripheral countries are suffering the most but Germany did not escape of a steep fall in September's production. In Asia, data continue showing a turn around in trade data. Singapor's exports showed a large contraction in October, especially to the US and Europe. On the other hand, Japan registered a robust third quarter GDP outturn, as expected, rebounding from March 11 earthquake and tsunami. Meanwhile, economic data in Latinoamerica continous resilient.
  The coming week Spanish general election result and the Rehn's Eurobond consultation paper will attract investors' attention. Additionally, November 23 is the deadline for the US so-called "Supercommittee" to report legislation to reduce the deficit by $1.2tr.

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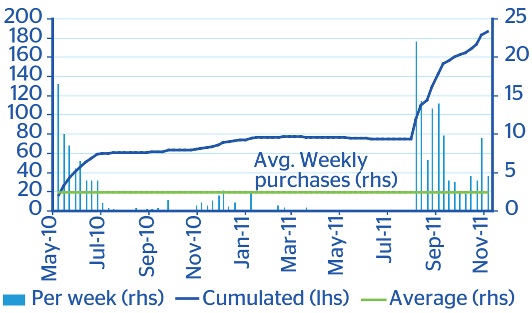
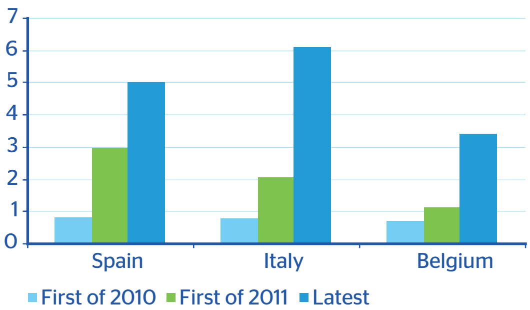
Chart 1
ECB: sovereign bond purchase program



Source: BBVA Research

Chart 2
Yields at sovereign auctions: 12-m bills (%)



Source: BBVA Research

Economic Analysis

The European debt crisis is escalating to a danger zone.

Market conditions are deteriorating across all Eurozone countries, with the exception of Germany (and the Netherlands so far) that remains as the sole safe-haven in the Eurozone. The situation is becoming increasingly fragile, as the debt crisis drags core-big countries such as France, and core-hard countries such as Austria and Belgium. At this stage probably the only defence line would come from a very aggressive and continuous intervention from the ECB.

Several indictors are reflecting financial strains have reached high levels. 1) European risk premium has increased across countries. Austria, Belgium and France have their 10Y bond spread increased by 13 bp, 28 bp and 17 bp, respectively. 2) Recent sovereign auctions are another warning indicator. Belgium, Spain, and France sold long-term and short-term debt this week by an amount below the maximum range, with low bid-to-cover ratios and at higher average yields. More over, Germany has faced a poor demand at its 2Y bond auction, suggesting that investors are not encourage to buy bonds at low yields. It is important to note that tensions have increased also for very short term maturities. 12 months bills have been sold at an average yield of 3.40% in Belgium and 5% in Spain. 3) European banks increased significantly their borrowing from the ECB in October and given market conditions it is expected to increase further in the coming months. 4) The progress on maximizing the capacity of the EFSF and its eventual implementation as a firewall to avoid the contagion across European is disappointing as the EFSF leverage may not be ready until December, or even later. Besides, the probability of success in leveraging the EFSF through the insurance approach is diminishing as market conditions deteriorate. All this uncertainties are being reflected in higher European countries' borrowing cost and also increasing funding cost for the The EFSF.

Inflation trend in US and Europe

Consumer price inflation eased in October, falling 0.1% following three months of higher-than-expected MoM growth. The negative headline figure primarily reflects a 2% decline in energy prices, mostly coming from a drop in crude oil prices. Food prices, which have been rising for more than a year, increased again but at the slowest pace since October 2010. Excluding food and energy, prices increased buy 0.1% for the second consecutive month. Leading by the core components medical care and apparel, which were partially offset by a decline in the transportation index. While these data are in line with Fed's expectations for easing inflation, it is likely that we will see a bigger jump in prices for November as oil prices rebound. Alternative measures suggest an increasing central tendency on the CPI. Meanwhile, in Europe neither energy prices nor food princes slowed as expected. The result was Eurozone Inflation has stabilized in October instead of falling. Even so, we continue to see a slowdown in headline inflation at the end of the year, to fall below the ECB target late in the first quarter of 2012. Still, several factors have appeared in recent weeks that could put a brake to this deceleration path. One is depreciation of the euro as a result of the eurozone weakness. The other is potential hikes in both taxes and administered prices introduced to sustain public finances in some member states.

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Global Interest Rates

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Markets

Interest Rates: risk aversion in Europe leads to very poor results at debt auctions

In the last week there have been various auctions in Europe, with one clear common denominator: they were all received badly by investors. On Monday there was an Italian auction, and although demand was greater than on previous occasions, the rate paid was the highest in 14 years (6.29%), meaning that the positive impact of Monti's newly formed government faded quickly. For Spain the bad news was twofold. Firstly, in Tuesday's auction of treasury bills the amount placed was below the target (EUR3.16bn vs. EUR3.5bn) and the rate paid was above 5% for 12M and 18M. Secondly, the new 10-year auction on Thursday also failed to meet the expected issuance target (EUR3.56bn vs. EUR4bn), with an average yield of 6.975%. The effects of the debt crisis have spread so far in Europe that problems are no longer limited to peripheral countries – countries such as France, Belgium and Austria have also been severely penalized. Despite these movements, it seems that the flight to quality has also started to show signs of tailing off, especially in the short term. For example, there was very little demand at the 2Y German auction (with a 0.25% coupon, the lowest ever) considering the new benchmark, and the issue was barely covered (bid to cover 1.1, also the lowest ever). Next week close attention must be paid to the announcement of the bonds that have been bought by the ECB under the Securities Markets Programme. The EUR4.5bn bought the previous week (even though the figure only covered the period up to 8 November) left the market a little cold, and next week's data could confirm a much more aggressive role for the ECB on the market.

Forex: European Issues Continue to Dominate FX Markets

Last week the majority of G10 and emerging market currencies weakened versus the USD in response to the ongoing contagion risks in the EMU. This was reflected by the high rates in the Italian, Spanish and Portuguese debt auctions. In addition, the economic data released in the US surprised on the upside, favouring an increase in appetite for USD. EUR depreciated by around 1.6%, as did other currencies within the eurozone such as GBP and CHF. Given that JPY continues acting as a safe haven, this is the only G10 currency which has strengthened; however, the possibility of further BoJ intervention still remains. LatAm, currencies registered a mixed performance, particularly the CLP which recorded a relatively worse performance in response to the drop in copper prices. The BRL and MXN depreciated by around 1.3% and 0.9% respectively, highlighting that they remain highly sensitive to the European situation, whilst COP, ARS and PEN appreciated as result of domestic flows. Lastly, most Asian currencies depreciated, however, they outperformed other emerging market currencies (especially those with higher exposure to Europe). Generally speaking, we think trading ranges will remain wide in the short term.

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Calendar: Indicators

Eurozone: Flash PMI composite (November, November 23rd)

Forecast: 45.9	Consensus: 46.2	Previous: 46.5

Comment: We expect the composite PMI to decline again in November, as increasing stress on the European sovereign debt crisis continues to weigh on confidence. We think that the strong deterioration observed in October is unlikely to be repeated, but the index is reaching levels close to those observed by mid-2008 when the Eurozone economy contracted. The projected fall would be more in line with that from the EC confidence survey, which has been in November more resilient in the previous month. Across components, the decline expected for October should be widespread, although stronger in manufacturing due to the fading effect from external demand support, while the decline in service confidence should reflect the weakness of domestic demand. Across countries, November figures will show further evidence that core countries are not immune to the problems in the periphery. **Market impact:** A sharp drop in PMIs could trigger further tensions in sovereign debt markets, putting pressure on European authorities to take further action.

Eurozone: Industrial new orders (September, November 23rd)

Forecast: -1.8% m/m	Consensus: -2.6% m/m	Previous: 1.9% m/m

Comment: Industrial orders are expected to have declined markedly in September, after the strong increase in August. These figures imply that orders in Q3 as a whole should have remained flat or even contracting slightly. In addition, confidence surveys also showed that the declining trend in manufacturing orders has intensified in Q4, suggesting a bleak outlook for the industrial sector in coming months. **Market impact:** Worse than expected outcomes could increase market fears not only of a stronger contraction of activity in the last quarter, but also of its persistence in early next year.

US: GDP, Preliminary Estimate (3Q11, November 22nd)

Forecast: 2.5% q/q	Consensus: 2.5% q/q	Previous: 2.5% q/q

Comment: Third quarter data released since the advance GDP estimate suggest little change in economic growth. Despite expectations for a widening of the trade balance in September, higher-than-expected export growth contributed to a better trade gap compared to the first and second quarters. However, declining business inventories may have offset any gains to GDP from the narrowing trade balance. On the consumption side, the advance estimate for PCE was stronger-than-expected and it is unlikely that the figure will be significantly revised upward. At the same time, gradual strengthening in the labor market and healthy retail sales suggest a low probability for downward revision to consumption. **Market Impact:** Markets remain volatile but most of the concern rests on developments in Europe, so minimal changes to the GDP estimate should incite little reaction. However, a significant downward revision could reignite fears of a double-dip recession and of US vulnerability to the European crisis.

US: Personal Income and Outlays (October, November 23th)

Forecast: 0.1%, 0.3% m/m	Consensus: 0.3%, 0.3% m/m	Previous: 0.1%, 0.6% m/m

Comment: Personal income and outlays are expected to grow again in October in line with other consumer data that has trended positive for the month. Wages and salaries have been healthy compared to earlier in the year, although average earnings in October increased at a slower pace than in the previous month. Consumer spending increased more than expected in September and is likely to be softer in October. However, strong retail sales and gradual improvements in consumer sentiments suggest positive spending growth. **Market Impact:** Recent data hints at ongoing improvements in consumer activity, so this release should cause little market anxiety unless the data suggest a deteriorating economy.

Taiwan: Exports (October; November 21st)

Forecast: 4.2% y/	Consensus: 3.8% y/y	Previous: 2.7% y/y

Comment: Taiwan's export orders are a leading indicator of the strength of external demand for much of Asia's high-tech economies. Export orders hit a two-year low in September, and recent export outturns in China, the Philippines, and Singapore, among others, show a clear weakening trend, especially from the US and Europe. We expect the deceleration trend in Taiwan's export orders to continue in October, partially offset by strong demand from China, where domestic demand remains strong. Demand for electronics such as semiconductors and components remains sluggish. **Market Impact:** Together with Japan's trade data to be released the same day, export orders will impact market sentiment; a worse than expected outturn would result in lower growth forecasts, and raise expectations of policy easing in Taiwan and the rest of the region.

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			Close	Weekly change	Monthly change	Annual change
Interest Rates (changes in bps)	US	3-month Libor rate	0.49	3	8	20
		2-yr yield	0.27	4	0	-23
		10-yr yield	2.00	-6	-16	-87
	EMU	3-month Euribor rate	1.47	0	-12	43
		2-yr yield	0.46	5	-16	-65
		10-yr yield	1.95	6	-11	-76
Exchange Rates (changes in %)	Europe	Dollar-Euro	1.354	-1.5	-1.8	-0.8
		Pound-Euro	0.86	0.2	-1.7	0.3
		Swiss Franc-Euro	1.24	0.0	-0.2	-9.0
	America	Argentina (peso-dollar)	4.26	-0.2	0.6	7.1
		Brazil (real-dollar)	1.78	1.9	0.6	3.6
		Colombia (peso-dollar)	1919	0.2	1.0	2.2
		Chile (peso-dollar)	511	2.5	-0.1	6.3
		Mexico (peso-dollar)	13.67	1.7	2.2	11.3
		Peru (Nuevo sol-dollar)	2.70	-0.2	-0.8	-3.8
	Asia	Japan (Yen-Dollar)	76.83	-0.5	0.1	-8.0
		Korea (KRW-Dollar)	1138.88	1.0	0.5	0.6
		Australia (AUD-Dollar)	1.004	-2.4	-2.3	1.9
Comm. (chg %)		Brent oil ($/b)	108.5	-4.9	0.1	28.7
		Gold ($/ounce)	1720.2	-3.8	4.8	27.1
		Base metals	527.4	-0.7	-1.5	-5.3
Stock Markets (changes in %)	Euro	Ibex 35	8281	-3.2	-6.4	-19.4
		EuroStoxx 50	2236	-3.8	-4.0	-21.4
	America	USA (S&P 500)	1218	-3.6	0.7	1.6
		Argentina (Merval)	2549	-7.4	-6.8	-21.8
		Brazil (Bovespa)	56666	-3.2	3.1	-20.1
		Colombia (IGBC)	12780	-0.9	-4.3	-14.5
		Chile (IGPA)	20561	-1.0	4.7	-10.7
		Mexico (CPI)	36150	-3.7	4.7	-1.2
		Peru (General Lima)	19294	-0.8	2.8	-5.4
		Venezuela (IBC)	114453	1.6	10.5	72.9
	Asia	Nikkei225	8375	-1.6	-4.5	-16.4
		HSI	18491	-3.4	1.0	-21.7
Credit (changes in bps)	Ind.	Itraxx Main	188	13	12	88
		Itraxx Xover	760	33	26	305
	Sovereign risk	CDS Germany	95	4	7	57
		CDS Portugal	1085	29	17	671
		CDS Spain	480	60	110	218
		CDS USA	52	2	8	---
		CDS Emerging	332	31	26	114
		CDS Argentina	986	67	16	305
		CDS Brazil	179	20	24	72
		CDS Colombia	177	17	22	68
		CDS Chile	137	10	15	57
		CDS Mexico	177	20	25	64
		CDS Peru	179	18	21	62

Source: Bloomberg and Datastream

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