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Weekly Watch
Global

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Economic Analysis

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Moderation in economic activity

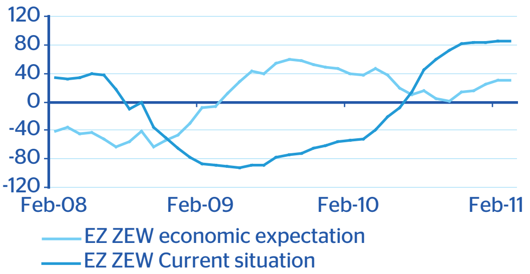
Economic activity has shown more signs of a slowdown in coming quarters while inflation pressures continue in the Euro zone (EZ). The German ZEW indicator of economic sentiment dropped more than expected by 4.5 points in May, driven by lower economic expectations. The fall in economic expectations confirms our baseline scenario that the Euro zone's growth rate will moderate in the coming quarter as higher commodity princes, weakness in the external demand outlook, interest rate hikes, and sovereign risk could weigh negatively on economic activity. This is not only the case in Germany, but also in the rest of the EZ countries, which are carrying out a strong consolidation process. We expect the EZ to grow around 0.3% q/q for the rest of the year after increasing by 0.8% q/q in 1Q11. Meanwhile, Eurozone HICP inflation was confirmed at 2.8% y/y in April with core inflation accelerating for the second month in a row (see highlight). The inflation trend supports our expectation of an additional rate hike in the July ECB meeting. This week in the US the economic indicators were quite weak. Housing data suggest that the housing market recovery will be slow (see highlight). Industrial production unexpectedly remained unchanged in April while capacity utilization decreased to 76.9% from 77.6% due to the contraction in Japanese activity. Besides this, core economic data such as personal consumption expenditures and non-residential investment are showing healthy growth rates that are expected to be maintained or slowly moderate, supported by a recovery in employment. All of this is in line with our view of a moderate pace of recovery in US economic growth in 2011. In LatAm countries, economic growth in the first quarter remains strong. However, in Chile, Venezuela and Mexico data suggest some moderation ahead.

The FOMC leans toward returning its focus to the Fed Funds target

Although FOMC members are still debating the ways to revert the non-standard measures, the last FOMC minutes revealed an eventual return of focus to the Fed Fund target rather than selling assets first (the FOMC may decide to sell assets later and more slowly). Overall, the Fed remains in no rush to raise rates due to the excess resource slack, although it is increasingly focused on inflation. In our view, the timing of the policy action will depend on the evolution of the data during the summer. Meanwhile, although the minutes of the mm MPC did not reveal any material change in their monetary policy view, the UK's economic weakness has been reflected in the minutes paving the way for a delay in the expectation of a rate hike in the UK.

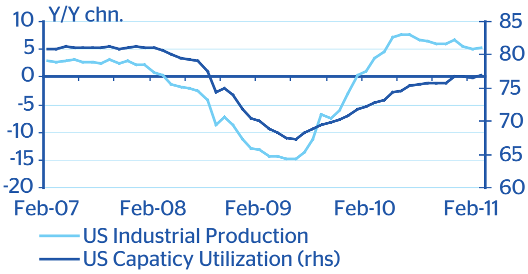
Next week: Relevant activity data in the US and Eurozone will be published. In the US durable orders, personal income and consumption for April and May consumer confidence will be closely watched. While in the EZ the May PMI index and Germany's HICP will attract the attention.

Chart 1
ZEW Suggest Slowdown in Coming Quarters



Source: Bloomberg

Chart 2
The US Industrial Activity Slowdown



Source: Bloomberg

Highlights

EZ: Core price pressures
Inflation could increase slightly to close to 3% y/y while average 2011 inflation would stand at 2.7% y/y.

US Housing prices: a tale of two markets
Distressed properties are determining house price statistics.

Europe increases pressure on Greece
Additional aid to Greece subject to immediate and substantial additional measures.

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Markets

A purely technical correction in rates

In the last few days yields have stabilized and even undergone upward corrections across the board in OECD curves. These movements were slightly larger in the case of the US. It is important to note that this movement is not a response to better cyclical conditions or improved peripheral risk premiums. In fact, the discrepancies between the messages from different EU institutions (the Commission on one hand and the ECB on the other) concerning potential restructuring of Greek debt has merely increased the noise, and core-periphery spreads remain near highs. In our view, this recent profile is more a reflection of factors linked to market dynamics. More specifically, there has been some profit taking on long positions in bonds, and the market has been somewhat more reluctant to continue pushing rates down, as they have approached important technical supports (0.45% in the 2Y Govt and 3.05% in the 10Y).

Positioning shakeout telling for FX

Over the past few months, we have been highlighting the notion FX markets were out of sorts with market positioning in USD's and other liquid currencies at or near extremes. Historically, the timing of a retracement is difficult to time, although we knew eventually the FX market would almost inevitably have to mean-revert. A few weeks ago as macro funds began taking profits in long commodity trades the move cascaded into the FX space with non-commercial accounts looking to cover its exceptionally large short-USD position. Given its near record highs, the long EURUSD trade was one of the most vulnerable FX pairs to correction. Within less than two weeks, EURUSD traded with a 1.49-handle, followed by a 1.40-handle before consolidating. Concurrently, we saw net-long EUR positioning materially cut and given EURUSD spot was just above 1.4400 at the time of the last CFTC survey, we expect more official positioning cuts when the next Commitment of Trader's Report is released.

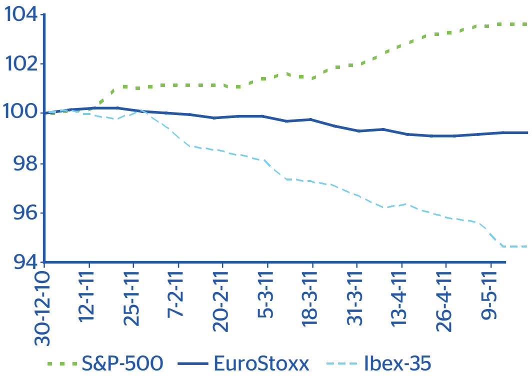
Calm but tense credit markets, awaiting a resolution for the Greek situation

In terms of credit markets' performance, synthetic indexes have continued to move within a narrow range over the last seven days, with the iTraxx Main flat at around 97bp, while financial indexes widened slightly: the iTraxx Fin Senior +1bps and the iTraxx Fin Sub +3bp. In terms of peripherals, Greece and Portugal remain in the spotlight, although the news flow regarding the two countries has not had a significant impact on the iTraxx SovX, which tightened 1bp.

Simply a rally or something more?

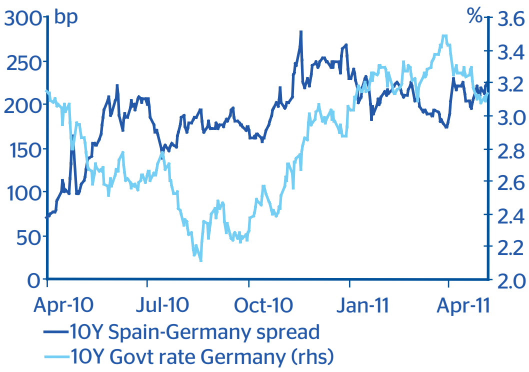
After hitting three-year highs, as we expected equity markets started to correct at the start of May, but not very sharply. The falls were led, as was to be expected, by sectors which are linked to commodity prices – the financial and cyclical sectors. In view of the weakness of rates at the long ends of curves, what is being priced in is a deterioration of the medium-term outlook for the cycle, as reflected by a clear increase in risk aversion on equity markets. Volatilities do not show significant downside risk, and following the rally of the last two days the main indexes are testing major resistances. Whether or not these levels are breached will depend on the macro data released for the United States and Asia and the progress made with the bailouts of peripheral European economies (Portugal and Greece). The positive note comes from EPS, since the consensus estimates for 2011-2012 remain healthy for the United States, and are starting to gather momentum in (non-emerging) Europe. And it is EPS that, in the long term, will determine how equity markets perform.

Chart 3
S&P-500, EuroStoxx and Ibex-35 EPS-2012e consensus



Source: Bloomberg

Chart 4
10Y German Govt rate vs. spread with Spain



Source: Bloomberg and BBVA Research

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Highlights

Core prices pressure Eurozone inflation

Recent HICP data, both in March and April, revealed that acceleration in the Euro zone inflation was mainly due to an increase in prices of the core component. Overall, core inflation has increased by around 0.7pp since late last year and around 1pp since about a year ago. While part of this increase was explained by seasonal effects, the upward surprise suggests greater indirect effects than previously anticipated. As businesses usually do not change their prices immediately, the indirect effects of higher commodity prices could have been delayed. The updated forecast with April data shows that headline inflation could increase slightly in coming months to annual rates close to 3% y/y, moderating in the last quarter of 2011, while the average annual inflation rate would stand at around 2.7%, roughly 0.3pp above the expectations three months ago. This acceleration in coming months could be explained by a slight increase in prices of both energy and core components. Meanwhile the expected abatement in the inflation trend at the end of the year should largely reflect a moderation of energy prices, and the core inflation should remain relatively stable at rates close to 2% y/y. We still do not see second round effects through higher wages putting the objective of medium-term price stability at risk. Wage negotiations are expected to yield moderate increases, while we project a slowdown in activity in coming quarters..

Housing prices: a tale of two markets

In the first quarter of 2011, the most followed housing price indexes (Federal Housing Finance Agency, Standard & Poors and CoreLogic) will show a renewed decline in existing house prices. This negative evolution of the average price could increase uncertainty about the probability of a double dip in housing prices and exacerbate financial stress. However, a deeper analysis of the composition of the indexes demonstrates that there are two different markets: first, the market for distressed properties, where prices are strongly adjusting and, second, the non-distressed market (new and existing) where prices have been more stable since the beginning of the economic recovery. The improved asset quality of financial institutions and the decline in foreclosure filings are allowing risk officers to process distressed properties through short-sales or public auctions without seriously compromising the loan portfolio. The trend of foreclosures suggests that the dual market in home prices could last to the end of 2011, when foreclosure filings will drop to a more manageable level. Average housing prices will stabilize once the distressed properties are cleared..

European Commission pressures Greece

The recent declarations from the chairman of the IMF mission in Greece and the conclusion of the last ECOFIN meeting suggest that Greece will not fulfil the consolidation program without taking additional measures. In this context, the ECOFIN has urged Greece to step up efforts in the coming days in order to pursue the fiscal consolidation targets, carry out the structural reforms and immediately begin the privatization process (privatization is currently considered the cornerstone for Greece). The adoption of decisive measures, which should be supported by a wide political consensus, is a necessary condition before the EU considers further steps to help Greece. As the next disbursement from the EU-IMF rescue package (€12 bn) was scheduled for June, and considering that it is absolutely conditional to a favourable assessment from the troika, the coming days and weeks are critical. At the ECOFIN press conference, it seemed that Europe could open the door for other measures, signalling that a Vienna-type initiative, where private investors are required to keep their exposure to Greece, and also a voluntary extension of maturities could be examined. From our point of view, the most probable outcome in the short-term is for continued support to Greece from Europe, assuming that Greece meets its commitments. It means that Europe could consider an additional aid program and a possible extension of the EFSM's loan payments...

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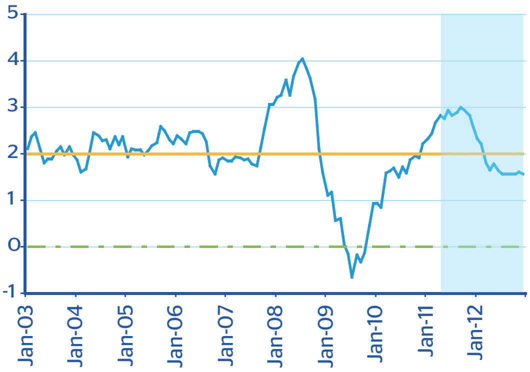
Chart 5
Eurozone: HICP inflation (% y/y)



Source: Eurostat and BBVA Research

Chart 6
Residential Foreclosures 3MMA. Units

Source: Bloomberg

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Calendar: Indicators

Eurozone: PMI Composite (May, May 23rd)

Forecast: 57.1	Consensus: 57.4	Previous: 57.8

Comment: The PMI composite is expected to decline in May, after an unexpected increase in April, partly reflecting the expected negative impact of higher commodity prices and interest rates hikes on economic sentiment, but also because the strong momentum in Q1 is unlikely to remain. Across components, we see industrial sentiment declining again, driven by the slowing sector recovery, while service confidence could be more resilient. In addition, we expect this data to provide a less upbeat picture, more similar to the EC Survey from two months ago (to be released next Friday). This would imply increased uncertainty on the economic outlook for coming months. **Market Impact:** A strong decline in PMI data could negatively affect markets, as a deterioration of confidence could lead to a sharper slowdown than is currently priced in.

Germany: Flash HICP inflation (May, May 27th)

Forecast: 2.8% m/m	Consensus: 2.7% m/m	Previous: 2.7% y/y

Comment: German HICP inflation is expected to remain broadly stable in May, after the significant acceleration observed in the previous month, as it should be partly due to seasonal effects. Nevertheless, we see inflation accelerating further in coming months to decline moderately at the end of the year. In addition, strong industrial inflation could end up passing through to consumer prices, supported by the dynamism of private demand. **Market impact:** A sharp increase in consumer inflation could raise the market's concerns about a tighter monetary policy stance by the ECB in its fight against dreaded second-round effects.

US: Gross Domestic Product (1Q11 Second Estimate, May 26th)

Forecast: 2.2% q/q saar	Consensus: 2.2% q/q saar	Previous: 1.8% q/q saar

Comment: The Bureau of Economic Analysis (BEA) estimated that the US economy grew 1.8% (QoQ, annualized) in 1Q11 on a seasonally adjusted basis compared to 3.1% in the previous quarter. The estimate indicates that personal consumption expenditures (PCE), private inventory investment and non-residential fixed investment positively contributed to growth, while government spending, residential investment and net exports dragged down the economic recovery in 1Q11. Recent macroeconomic data indicate that the BEA would raise its 1Q11 economic growth estimate from 1.8% to 2.2% most likely due to better than expected construction spending and private inventories. **Market impact:** If BEA raises its growth estimate more than expected, stock markets will increase accordingly, reflecting better economic prospects.

US: Personal Income and Outlays (April, May 27th)

Forecast: 0.5%, 0.5% m/m	Consensus: 0.4%, 0.5% m/m	Previous: 0.5%, 0.6% m/m

Comment: In March, personal income and spending increased by 0.5% and 0.6% m/m, respectively. However, most of the increase was due to increase in nominal prices. After removing price changes, personal spending increased moderately by 0.2% compared with an increase of 0.5% in the previous month. We expect personal income and spending to continue to rise in April similar to the previous month. However, the increase will remain low in real terms. **Market impact:** If real personal spending jumps more than 0.4%, it would be a sign for strong PCE and real economic growth in 2Q11.

Japan: Export growth in (April, May 25th)

Forecast: -11.0% y/y	Consensus: -12.7% y/y	Previous: -2.3% y/y

Comment: First quarter GDP growth was released this past week, at -3.7% (q/q, saar), underlining the risks to growth following the March 11 earthquake and tsunami. Disruptions to supply chains and power shortages are expected to continue weighing on production and exports in the coming months. Exports in April, the first print reflecting the full-month impact of the quake, are likely to have fallen further from March's level. **Market impact:** A lower-than-expected outturn could cause markets to price in a lower growth outlook for 2011 and dampen sentiment.

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			Close	Weekly change	Monthly change	Annual change
Interest Rates (changes in bps)	US	3-month Libor rate	0.26	0	-2	-24
		2-yr yield	0.53	0	-13	-24
		10-yr yield	3.17	0	-23	-6
	EMU	3-month Euribor rate	1.43	1	9	74
		2-yr yield	1.83	6	0	132
		10-yr yield	3.12	4	-19	45
Exchange Rates (changes in %)	Europe	Dollar-Euro	1.433	1.7	-1.1	14.2
		Pound-Euro	0.88	1.2	-0.2	1.4
		Swiss Franc-Euro	1.26	0.0	-2.4	-12.6
	America	Argentina (peso-dollar)	4.08	0.0	0.0	4.5
		Brazil (real-dollar)	1.62	-1.1	2.5	-13.0
		Colombia (peso-dollar)	1816	0.3	1.9	-8.9
		Chile (peso-dollar)	469	0.2	0.0	-13.6
		Mexico (peso-dollar)	11.61	-1.2	-0.2	-10.8
		Peru (Nuevo sol-dollar)	2.75	-0.3	-2.3	-3.1
	Asia	Japan (Yen-Dollar)	81.58	1.1	-1.0	-9.2
		Korea (KRW-Dollar)	1082.28	-0.9	0.3	-10.6
		Australia (AUD-Dollar)	1.070	1.2	0.3	29.4
Comm. (chg %)		Brent oil ($/b)	112.0	-1.6	-9.6	56.2
		Gold ($/ounce)	1503.4	0.6	0.1	27.7
		Base metals	605.1	0.6	-3.5	25.2
Stock Markets (changes in %)	Euro	Ibex 35	10415	0.6	-1.1	10.7
		EuroStoxx 50	2904	0.3	-0.6	12.8
	America	USA (S&P 500)	1344	0.4	1.0	23.5
		Argentina (Merval)	3386	0.2	-0.8	59.4
		Brazil (Bovespa)	62367	-1.4	-7.0	3.5
		Colombia (IGBC)	14115	-1.0	-1.6	18.9
		Chile (IGPA)	22804	-0.7	1.9	28.7
		Mexico (CPI)	35276	0.7	-4.2	15.2
		Peru (General Lima)	22034	-0.2	17.2	51.3
		Venezuela (IBC)	78139	0.9	10.3	26.3
	Asia	Nikkei225	9607	-0.4	0.0	-1.8
		HSI	23199	-0.3	-2.9	18.7
Credit (changes in bps)	Ind.	Itraxx Main	98	1	-1	-22
		Itraxx Xover	357	3	-8	-230
	Sovereign risk	CDS Germany	38	0	-6	-5
		CDS Portugal	625	7	-11	303
		CDS Spain	243	7	0	41
		CDS USA	48	5	3	---
		CDS Emerging	204	-3	0	-100
		CDS Argentina	596	7	25	-703
		CDS Brazil	100	-2	-9	-48
		CDS Colombia	98	-3	-3	-81
		CDS Chile	65	3	4	-46
		CDS Mexico	98	-1	-3	-49
		CDS Peru	131	-1	-18	-16

Source: Bloomberg and Datastream

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