Weekly Watch

Global

Madrid, 21 October 2011

Economic Analysis

Financial Scenarios
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Eagerly waiting for Europe to stop contagion

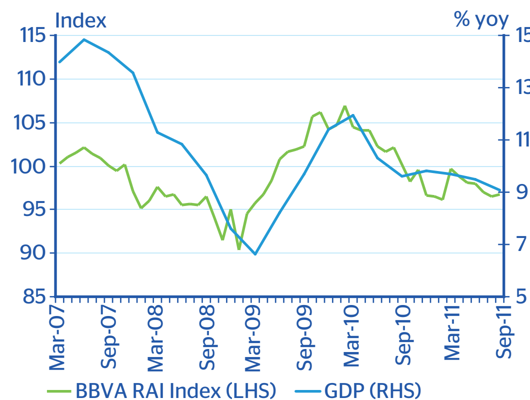
- **Mood swings as investors wait for the outcome of European meetings**
  Risk appetite has moved up (down) in tandem with expectations running high (low) that the European council this weekend will (will not) deploy a comprehensive plan to restore confidence. Mood swings have ignored somewhat better-than-expected 3Q US economic data which has reduced fears that the economy might face a double-dip recession.

- **A package to reverse the downward trend in confidence is expected**
  The issues expected to be addressed in coming European meetings are 1) the revisions of the banking sector recapitalization requirements, 2) new measures to tackle the Greek debt problem, 3) maximise the effectiveness of the EFSF's remaining lending capacity, and 4) revision of the European Treaty in order to speed up the process needed to address the European governance issue.

- **More sign of growth support policies in Emerging markets**
  Central banks in Thailand and the Philippines kept their benchmark rates unchanged, at 3.50% and 4.50% respectively, as the former stated its willingness to ease policy rates if necessary to support businesses hurt by recent flooding. The Philippines' shift to neutral comes one week after the government unveiled additional fiscal stimulus to the economy, and we have begun seeing a marked shift to either monetary accommodation. The Central Bank of Brazil also has cut interest rates by 50bp to 11.5%, and we expect another 50bp cut.

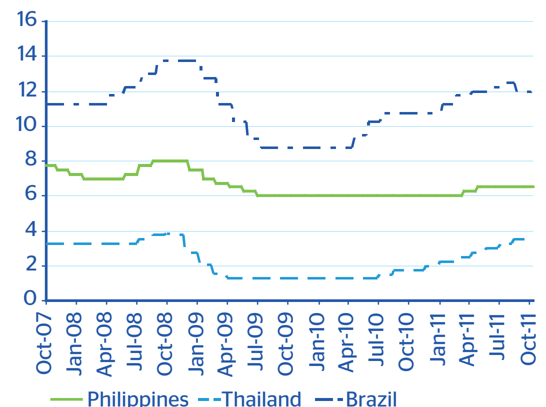
- **China's growth continues to point to a soft-landing**
  This week, China released 3Q GDP which, despite disappointing markets slightly, showed that growth remains on track for a soft landing.

Chart 1
China's 3Q GDP eases in line with a soft-landing



Source: Bloomberg and BBVA Research

Chart 2
Monetary tightening appears to be over in EM



Source: BBVA Research

Economic Analysis

A package to reverse the downward trend in confidence is expected

All eyes will be on the several European meetings taking place this weekend and on October 26th, after the President of European Commission announced a road map to address the European debt crisis, last week. The issues expected to be addressed in those meetings are 1) the revisions of the banking sector recapitalization requirements, 2) new measures to tackle the Greek debt problem, 3) maximise the effectiveness of the EFSF's remaining lending capacity, and 4) revision of the European Treaty in order to speed up the process needed to address the European governance issue. Regarding banking sector recapitalization, there are rumours that the EBA has already re-estimated recapitalization requirements which assuming a Tier1 ration of 9% would amount to €100bn. First, banks have to raise capital themselves. If they can not, then they would have to ask for it to national governments. Finally, if governments can not afford to recapitalize banks, the EFSF would provide the financial help. Concerning Greek debt problems, our view is that a higher Greek PSI seems inevitable. Thus, the EU may ask Greek bondholders to take a higher voluntary haircut (from current 21% to something between 30 and 40%).

Considerable stress in euro area sovereign debt markets continues as measures taken up to now have not restored confidence. There is a need to maximise EFSF's "firepower" given its limited existing EFSF lending capacity, Germany's public opposition to an increase in resources, and ECB's opposition to provide leverage to the EFSF. One solution would be to leverage EFSF's capital by providing insurance to cover the first tranche of losses (ie, partial credit protection) of new debt issuance. The idea is to: a) provide incentives to both private sector bond investors (to encourage private sector lending as creditors of new debt issuance will not longer be subordinated) and recipients of EFSF guarantees (therefore, conditionality is likely) to achieve a substantial reduction in credit spreads, increasing debt raising capacity at sustainable interest rate levels, and b) use EFSF remaining lending capacity in the most efficient way and without a burden increase on guarantor Member States. This plan has led to optimistic conclusions about the possibility of a fivefold increase in the fund's "firepower": leverage amounting to more than €2 trillion has been on the headlines over the past week. How do you get this number? Theoretically, the EFSF has €440bn of effective lending capacity which could be leveraged. If this amount is used to insure 20% of the first losses of new debt issuance, it would thus be possible to insure five times of new bond purchases (ie, €440bnx5= €2.2trillion). What is the number we are likely to get? There are committed resources from EFSF for existing programs that need to be subtracted: €26bn for Portugal and €17.7bn for Ireland. Besides, assuming that the IMF will co-finance 1/3 of the second €109 bn bail-out agreed for Greece at the July 21 EU summit, a further €73bn of EFSF resources is committed. Lastly, resources to recapitalize banks also need to be discounted. Estimates for the required amount of capital are between €50 bn and €200bn. Our view is that an announcement along the low end of that range is the most likely. Therefore, additional resources between €50bn and €100bn would also be subtracted. This brings available EFSF resources to a range of €224bn-€274bn. As a result, the effective "firepower" for the EFSF should be enough to insure between €1.1 and €1.4 trillion of new sovereign debt issuance. A higher (lower) partial credit protection would effectively reduce (increase) the leverage capacity of remaining resources. If the "insurance program" is actually implemented, it should be enough to cover Italian and Spanish new bond issuance needs (deficit + refinancing) over the next three years, which we estimate at around €850bn. Nevertheless the program faces some risk such as legal framework issues, a segmentation of the bond market and eventually the risk is that investors may not find the partial insurance program attractive.

China's growth continues to point to a soft-landing

China released its Q3 GDP and September activity indicators. Although market responded negatively to the data outturns, they are broadly in line with expectations and show that the economy is still on track for a soft-landing. The third quarter GDP outturn shows a further moderation in growth to 9.1% y/y (BBVA: 9.2% y/y; consensus: 9.3%), slightly below consensus and down from 9.5% y/y in the second quarter. On a sequential basis, quarterly growth remained strong, at 2.3% q/q seasonally adjusted (9.5% annualized), only slightly down from 2.4% q/q in the second quarter. The moderation in our view reflects the impact of previous tightening measures, a dampening effect from slowing property prices and rising debt burdens of SMEs, as well as a gradual slowdown in export growth. Nevertheless, the robust outturn should help to keep risks of a hard landing at bay. The readings of other activity indicators for September also suggest robust growth momentum. On the demand side, September retail sales growth rose to 17.7% y/y (consensus: 17.0%), up from 17.0% y/y in August. Urban fixed asset

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investment (YTD) grew by 24.9% y/y (consensus: 24.7%), up from 22.9% y/y in August. On the supply side, industrial output increased to 13.8% y/y in September (consensus 13.3%) from 13.5% y/y in August. It is remarkable that the strong economic outturns were realized under relatively tight monetary conditions. New loans in September came in at RMB 470.0 billion (consensus: RMB 550.0 billion), down from RMB 548.5 billion in August, implying year-on-year credit growth of 15.9%, down from 16.4% in August. M2 growth in September further slipped to 13.0% y/y from 13.5% y/y in August, well below market consensus of 14.0%, possibly reflecting a shift in deposits toward higher yielding wealth management products. Taken together, the data show both strong production and domestic demand conditions for the month of September. The outturns are broadly consistent with our 9.2% annual growth projection for 2011, although uncertainties to the global outlook pose downside risks to our 8.9% growth projection for 2012. With inflation and growth moderating in line with expectations, we believe monetary policy will remain on hold for the next few months.

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Global Interest Rates

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Interest Rates: Rating agencies in the spotlight

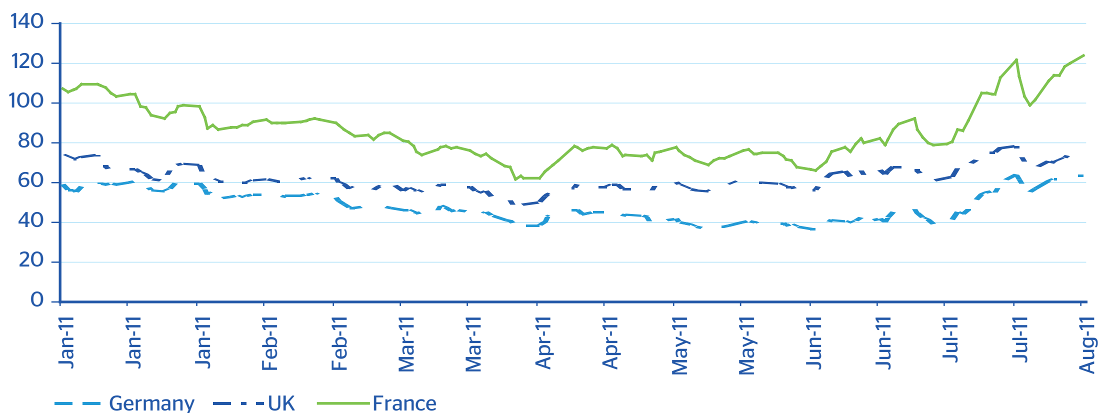
France's outlook under review: Recent warnings made by Moody's to France on a possible negative outlook in the next three months have renewed market fears of a downgrade from the country's current AAA rating. Should this risk materialize any quick resolution of the European sovereign debt crisis would be put in danger, as most of the alternatives on the EU's table are based on reinforcing the EFSF, whose AAA guarantees would be reduced by 36%.

Spain downgraded: Moody's has lowered Spain's government bond rating two notches from Aa2 to A1 and put it on negative outlook, following in the footsteps of the recent downgrades from S&P and Fitch. The recent widening in the Spain-Germany spread (now at 330bp) may continue in the coming days as Germany continues to collect flight to quality flows (other core issuers like France are no longer playing this role).

Forex: EU summit continues to drive FX market

Risk appetite increased in financial markets at the start of the week following the G20 meeting in Paris at the weekend. G20 finance ministers and central bank governors endorsed parts of the emerging plan to avoid European crisis contagion and to bolster banks. The group also set 23 October, the European leaders' summit in Brussels, as the deadline for EMU to deliver its final plan. Markets were particularly upbeat on the IMF request "to further consider new ways to provide on a case-by-case basis short-term liquidity" to countries facing external shocks, which may open the door for the IMF to aid Europe in future if necessary. Nevertheless, risk sentiment worsened quickly following comments by Germany's finance minister who dampened expectations that a definitive solution to the sovereign debt and banking crisis would be reached at the 23 October meeting. This was confirmed by Thursday's announcement of an additional summit on 26 October in which the questions that the markets are most interested in, namely the leverage of the EFSF and a larger haircut for Greece's debt will be agreed on. Market sentiment will continue to be driven by comments regarding possible outcomes of the European summits. FX markets showed high intraday volatility during the week, a situation which we expect to continue. Recent rallies in EURUSD and other risk-sensitive currencies will only be sustained if markets see a "successful" and "solid" resolution to the peripheral crisis. Since market sentiment is running high as many outcomes have already been priced in, we caution the possibility that not all expectations may be met, thus leading to more volatility in the markets near term.

Chart 3
France 5Y CDS has deteriorated further



Source: BBVA Research

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Calendar: Indicators

Eurozone: Flash PMI composite (October, October 24th)

Forecast: 48.6	Consensus: 48.8	Previous: 49.1

Comment: We expect the composite PMI to decline again in October, remaining well below 50 points threshold but still slightly above the levels observed by mid-2008 at the beginning of the last downturn. The sovereign debt crisis is clearly impacting confidence in the eurozone. Across components, we expect both the manufacturing and services indexes to fall again. The former could be reflecting the fading from external demand support, while the later could be advancing a weaker domestic demand. In addition, the declining trend is expected to be observed across member states. **Market impact:** A sharp drop in PMIs in core countries could signal the return to recession in the eurozone.

Eurozone: M3 (September, October 27th)

Forecast: 2.7% y/y	Consensus: 2.9% y/y	Previous: 2.8% y/y

Comment: Eurozone lending data for September are expected to reflect a still sluggish credit performance. M3 growth is projected to have declined slightly, after the strong rebound observed in August, after hovering around 2% since the late 2010. Across its components, loans to households are expected to have increased slightly as observed in recent months, but showing a significant deceleration in Q3. Loans to non-financial corporations are also likely to increase marginally, although the quarterly growth rate in Q3 could turn out as more resilient, remaining broadly stable since the beginning of the year. **Market impact:** Worse than expected outcomes could increase market fears about the sovereign debt crisis could end tightening credit to private sector, resulting in another drag on economic growth.

US: Gross Domestic Product, Advance (3Q11, October 27th)

Forecast: 2.2% q/qa	Consensus: 2.3% q/qa	Previous: 1.3% q/qa

Comment: The advance estimate for 3Q11 GDP is expected to show improvements over last quarter despite prolonged weakness in economic activity. While the housing and manufacturing sectors continued to struggle, nonresidential investment likely strengthened. Also, personal consumption increased from 2Q11 despite historically-low levels of consumer confidence. Furthermore, the trade balance appears to be narrowing due to a boost in exports. Although the fiscal situation in mid-August left a sour mark in 3Q11, growth is likely to accelerate in line with our expectations for a better 2H11. **Market Impact:** Markets have already faced significant weakness in economic reports, so an improvement over 2Q GDP will bring much-needed relief. Worries of a double-dip recession have eased, however, a surprise to the downside could trigger another panic.

US: Employment Cost Index (September, October 28th)

Forecast: 0.5% q/q	Consensus: 0.6% q/q	Previous: 0.7% q/q

Comment: The Employment Cost Index is expected to increase in 3Q11 although at a slower pace than in 2Q11. Nonfarm payrolls and average earnings were little changed from last quarter, suggesting that the wage component of the index will remain relatively steady. Throughout the past year, benefits have been increasing far more quickly than wages as companies try to retain competent workers in order to expose themselves to less risk. Since benefits make up only 30% of total compensation costs, we expect the overall index to grow at a slightly slower pace than in the second quarter. **Market Impact:** Employment costs have been on a steady trend in the past year. Given weak labor conditions and significant resource slack, continued growth in the index should warrant little reaction from the markets.

Australia: Australia's inflation for Q3 (October 26th)

Forecast: 3.3% y/y	Consensus: 3.5% y/y	Previous: 3.6% y/y

Comment: Australia's inflation probably peaked in Q2 and should trend down in the coming quarters. That said, the Q3 outturn is likely to remain above the RBA's inflation target range of 2-3%. Given the seriousness the RBA attaches to its Inflation targeting regime, the outlook for inflation has been crucial as a guide to the future course of interest rates in Australia. Many forecasters have been looking for signs of an easing in policy rates to boost domestic demand against the backdrop of the current global downturn, as hinted in the last RBA meeting minutes. Australia has kept its policy rate unchanged at 4.75% since November 2010. We expect no rate cut in the RBA's policy meeting in November, despite the likelihood of a rate cut is growing in the near future. **Market impact:** A lower-than-expected outturn will increase the likelihood of a rate cut by the RBA in its next policy meeting in early November.

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			Close	Weekly change	Monthly change	Annual change
Interest Rates (changes in bps)	US	3-month Libor rate	0.42	1	6	13
		2-yr yield	0.27	1	8	-8
		10-yr yield	2.21	-3	36	-34
	EMU	3-month Euribor rate	1.59	1	5	56
		2-yr yield	0.65	-1	21	-35
		10-yr yield	2.11	-9	33	-37
Exchange Rates (changes in %)	Europe	Dollar-Euro	1.390	0.4	1.2	-0.2
		Pound-Euro	0.87	-0.6	-0.8	-1.8
		Swiss Franc-Euro	1.23	-0.9	0.0	-10.0
	America	Argentina (peso-dollar)	4.23	0.4	1.1	7.1
		Brazil (real-dollar)	1.78	2.3	-3.2	4.3
		Colombia (peso-dollar)	1901	0.2	1.1	4.2
		Chile (peso-dollar)	513	2.6	2.6	5.3
		Mexico (peso-dollar)	13.60	2.6	1.3	9.9
		Peru (Nuevo sol-dollar)	2.72	0.1	-1.3	-2.6
	Asia	Japan (Yen-Dollar)	76.13	-1.6	-0.3	-6.5
		Korea (KRW-Dollar)	1147.20	-0.8	-0.4	1.8
		Australia (AUD-Dollar)	1.034	0.4	1.3	5.5
Comm. (chg %)		Brent oil ($/b)	111.1	-3.1	0.7	34.0
		Gold ($/ounce)	1636.4	-2.6	-8.2	23.2
		Base metals	535.6	-0.7	-4.1	-1.9
Stock Markets (changes in %)	Euro	Ibex 35	8872	-1.2	8.1	-18.8
		EuroStoxx 50	2333	-1.0	11.2	-18.8
	America	USA (S&P 500)	1236	0.9	5.9	4.5
		Argentina (Merval)	2831	4.2	7.6	-0.7
		Brazil (Bovespa)	55350	0.6	-1.1	-20.4
		Colombia (IGBC)	13477	0.9	-1.2	-15.3
		Chile (IGPA)	19771	2.8	1.6	-11.7
		Mexico (CPI)	34846	0.0	2.4	-0.8
		Peru (General Lima)	18735	-0.9	-6.0	-0.2
		Venezuela (IBC)	103990	3.9	3.3	55.2
	Asia	Nikkei225	8679	-0.8	-0.7	-7.9
		HSI	18026	-2.6	-4.2	-23.4
Credit (changes in bps)	Ind.	Itraxx Main	183	10	-4	84
		Itraxx Xover	757	19	-46	299
	Sovereign risk	CDS Germany	92	-3	-7	59
		CDS Portugal	1122	-21	-19	776
		CDS Spain	388	8	-44	183
		CDS USA	43	-5	-9	---
		CDS Emerging	319	22	-25	110
		CDS Argentina	1003	70	24	263
		CDS Brazil	162	9	-34	63
		CDS Colombia	164	7	-33	62
		CDS Chile	126	1	0	58
		CDS Mexico	158	7	-42	50
		CDS Peru	165	8	-38	62

Source: Bloomberg and Datastream

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