Weekly Watch
Global

Madrid, 23 September 2011
Economic Analysis

Financial Scenarios
Sonsoles Castillo
s.castillo@bbva.com
+34 91 374 44 32

Javier Amador
javier.amadord@bbva.com
+34 91 374 31 61

Cristina Varela Donoso
cvarela@bbva.com
+34 91 537 7825

María Martínez Álvarez
maria.martinez.alvarez@bbva.com
+34 91 537 66 83

Felipe Insunza
felipe.insunza@grupobbva.com
+34 91 537 76 80

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Worries spread

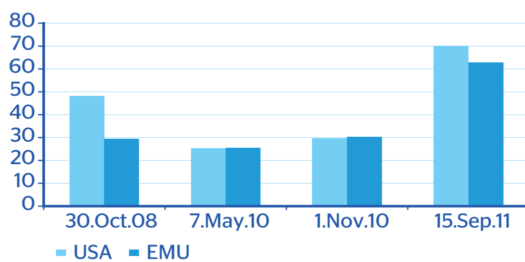
Recent economic indicators and reports intensified worries about the global growth outlook. Renewed pessimism was driven by a bleaker US outlook signalled by the Fed ("significant downside risks" cited in FOMC's statement), and weaker survey results for China and the Eurozone in September. Concerning the latter, flash PMIs were weaker than expected, with readings from core countries (France and Germany) lower than anticipated. Although the Fed did not disappoint and delivered the already priced in attempt to flatten the yield curve ("Operation Twist"), market worries increased due to a combination of factors: a) the expectation that the impact from this new measure will be small, b) the fear that the Fed has little room to counteract the shortage of demand (both because of political pressures to avoid another round of easing from the Fed and given that even if the Fed eventually leans to implement QE3, its impact might be small, especially as additional funds are not likely to be channelled to risky assets in times of extreme uncertainty), and c) the structural weakness of the US economy cited by the FOMC in its statement. As perceived risks heightened, risky assets suffered a lot. This was driven not only by the bleaker growth outlook in the US and the Eurozone, but also because the deterioration of financial conditions in the EZ spread to all risky assets. These fears were also fuelled by S&P's downgrade to A from A+ of the Italian rating. Emerging market currencies depreciated sharply this week. The Central banks of Peru and Brazil announced measures to provide USD funding to reduce pressure on their currencies. Regarding the European debt crisis, the new measures announced by the Greek government may open the way to the disbursement of the 6th loan tranche of €8bn. This could reduce fears about a disorderly Greek default, but will not dissipate uncertainties. At most it will temporarily reduce panic until the 7th tranche has to be disbursed. Furthermore, although the probability of the German parliament passing the EFSF amendment has increased, the risk lies in other small countries such as Slovenia where the government was ousted in a confidence vote, delaying the approval of the EFSF.

As regards to G20's pledge: action speaks louder than words

Given the need to address the "renewed challenges facing the global economy" G20 policymakers pledged "to take all necessary actions to preserve the stability of banking systems and financial markets". The statement also cited that central banks will continue to provide liquidity as required and will continue to support the economic recovery. Market reaction to such pledge was mild as markets are expecting concrete actions rather than promises from policymakers. Meanwhile, central Banks were very active this week. Not only did the FED announce its "Operation Twist", but it was more aggressive than the market expected, in both scale and in the reinvestment of non-Treasury securities in agency MBS. Meanwhile, BoE's minutes showed that the likelihood of another round of asset purchases increased substantially and if financial conditions persist one more month it is likely. The problem is that neither pledges nor actions from central banks are diminishing fears or regaining any confidence.

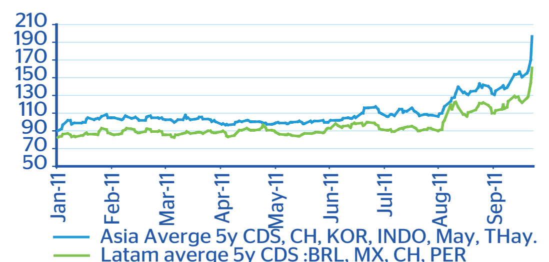
Next week Germany parliament votes EFSF amendment.

Chart 1
Bonds volatility (30d MA)



Source: Bloomberg

Chart 2
Risk has spread to emerging markets



Source: Bloomberg and BBVA Research

Highlights

Growth forecasts revised downwards, especially in advanced economies

Several factors such as downward surprises on growth of developed economies, the intensification of EZ sovereign debt woes and renewed concerns about bank solvency have cut growth expectations.

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Global FX
Chief Strategist
Dustin T. Reid
Dustin.Reid@bbvany.com
+1 212 7281707

Global Interest Rates
Interest Rates Europe and USA
José Miguel Rodríguez Delgado
josemiguel.rodriguez@grupobbva.com
+34 91 374 68 97

Global Credit
Credit Europe
Antonio Vilela
antonio.vilela@grupobbva.com
+34 91 374 56 84

Markets

Interest Rates: the twist is here

The measures announced by the Fed yesterday were in line with what the market had been anticipating in the preceding weeks: a new round of straightforward intervention in the Treasury market. More specifically, it announced that from now and until the end of June 2012 it will buy USD400bn of Treasury securities with remaining maturities of 6 years to 30 years and sell an equal amount of Treasury securities with remaining maturities of 3 years or less. The distribution of these purchases is detailed in the Table 1.

Initial reaction in the curve up to the 10Y segment was in line with what could be expected: only 2bp up the 2Y and around 8bp down in the 10Y. Our assessment is that most of the potential directional impact of this strategy on the curves has already been priced in by the market since the end of August (when an action similar to this one started to be anticipated by the curves). Since then 10Y yields have corrected around 40bp whereas the 2Y has remained relatively flat at around 0.20%. From this point of view, we consider that yields in the 10Y sector should not show additional major reactions to this new program: the area around 1.75/1.70% should serve as a floor for 10Y yields.

The 2 to 30Y segment may still benefit somewhat from this surprising bias in the Fed's targeted pattern for reinvestments. The immediate reaction has been a 20bp downward shift in the 30Y yield and a flattening of around 15bp in the 10/30Y. This may well be the pattern we are most likely to see in this part if the cure in the next few months, mainly as it can be considered part of the Fed's strategy: by maintaining such relatively and absolutely low levels for these rates it is seeking to support the mortgage markets. From this point of view, 2.80% for the 30Y could be feasible in the short term but not in the medium to long term.

Forex: themes to watch in Latam FX

As EM FX is materially offered, there are numerous key issues we are watching in the Latam market with two in particular. The first is clearly how global risk sentiment will continue to affect flows into EM FX and particularly Latam FX. Here, we believe the recent sell-off appears overdone and with BBVA's Economics team calling for a successful resolution to the European peripheral debt crisis, we can see Latam FX generally appreciating once this current bout of risk aversion finishes. The second key issue is surrounding new macro prudential measures and intervention in the FX market. This year has seen a number of attempts to impose new regulatory frameworks in order to try and cease local currency appreciation; Brazil is the clear standout here. Given recent retracements in spot prices, imminent new macro prudential measures are now likely on the back burner. Additionally almost all of the major Latam central banks (CB's) have directly intervened in FX markets, some in good size, this year. Given the recent reversal in spot prices, a key theme to watch will be if Latam CB's will try to quell volatility even when domestic currencies are depreciating or are CB's content enough with the directional change? Generally we would expect most Latam CB's not to try and quell FX volatility if their domestic currency continues depreciating, given many officials have perceived Latam FX as overvalued for quite a while.

Credit: volatility in credit markets continues

This week we have seen an increase in volatility in credit markets, following the brief respite of the previous week. Recent newsflow (disappointing operation "Twist", ratings agencies' actions...) has not helped improve the situation, which has led to a generalised widening in the synthetic indices, with the iTraxx Main and the iTraxx Financial Senior surpassing the 200bp and 300bp barriers, respectively. That being said, the iTraxx Main widened 22bp to 200bp, while the iTraxx SovX widened 33bp to 357bp. In financials, the iTraxx Financial Senior and Subordinate have widened by 39bp and 77bp, respectively, to 304bp and 542bp.

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Table 1
A rundown of the Fed's Treasury portfolio under the new program

	0-3 Y	3-6Y	6-8 Y	8-10 Y	10-20 Y	20-30 Y
Investment distribution in new program*	-100%	0%	32%	32%	4%	29%
Amount to purchase (USD bn)	-400	0	128	128	16	116
Current SOMA holdings (USD bn)	527	466	303	94	87	74
% ot total outstanding	15%	25%	39%	18%	32%	14%
Amount outstanding off-Fed (USD bn)	2756	1394	460	408	181	423
Future SOMA Holding (USD bn)	127	466	431	222	103	190

* Remaining 3% in 6-30Y TIPS
Sources: Federal Reserve and BBVA Research

Economic Analysis

Economic Scenarios
Juan Ruiz
juan.ruiz@bbva.com
+34 91 3745887

Highlights

Growth forecasts revised, especially in advanced economies

In August, there were three major shocks that substantially altered our forecasts. The first of these shocks was a number of downward surprises in developed economies' growth in the first and second quarter. In particular, historical U.S. growth figures were revised down (including, importantly, the first quarter of 2011), indicating that the structural situation of the U.S. economy is seemingly weaker than thought at the beginning of the summer. In addition, downward revisions of growth in the first part of the year have a significant base effect on the 2011 and 2012 averages.

The second shock is related to the intensification of European sovereign debt woes. Although the July 21 summit exceeded expectations in terms of governance reforms in the EU (e.g. improvements to the EFSF), markets still have serious doubts about the implementation of these agreements and the ability of the EFSF to address a problem that now extends to Italy (and Spain).

The third element relates to renewed concerns about bank solvency, as a result of the fallout from the sovereign debt crisis in Europe. The perceived risk in European banks has increased, many of them being highly exposed to government debt from countries with high risks of default. This has raised doubts about the solvency of some banks and has significantly hindered bank financing, including credit lines in US dollars.

These three factors have led to increased risk premiums in peripheral countries, but also in Spain and Italy. It has also led to an increased global risk premium, widespread adjustments in stock markets and a strong refugee effect, which has driven American and German bond yields to record lows. Finally, there has been a marked deterioration in consumer and business confidence in August, especially in Europe, including core countries.

In this context, the main change from our July forecast reflects a sharp downward revision in U.S. growth, largely driven by the base effects mentioned above. This adjustment also affects economies, like Mexico, which are closely related to the American business cycle. Also in Europe and Spain there are downward revisions in growth, more moderate than in the U.S., due to the impact of financial stress and weak activity data in the second quarter. In all three cases (U.S., Europe and Mexico), weaker activity means central banks will delay further interest rate increases until 2013 at least.

In other regions (Asia and South America), adjustments to our growth projections are lower, reflecting a lower trade and financial exposure to Europe and increased reliance on the prospects in China, with few changes with respect to August.

Table 2
GDP Forecasts

	Current		Previous	
	2001	**2011**	**2011**	**2012**
US	1.6	2.3	2.5	2.7
EZ	1.7	1.0	2.0	1.3
Spain	0.8	1.0	0.9	1.3

Source: BBVA Research

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Europe
Agustín García Serrador
agustin.garcia@grupobbva.com
(+34) 91 374 79 38

US
Kim Fraser
kim.fraser@bbvacompass.com
+1 713 881 0655

Asia
Zhigang Li
zhigang.li@bbva.com.hk
+852 2582 3162

Calendar: Indicators

Eurozone: Flash HICP inflation (September, September 30th)

Forecast: 2.8% y/y	Consensus: 2.5% y/y	Previous: 2.5% y/y

Comment: We expect inflation to increase by around 0.3pp to 2.8% y/y in September, driven by a rebound in prices on non-energy industrial goods due to methodological changes in the treatment of seasonality, while prices of energy and food are also expected to increase slightly. Given the limited information available to model this methodological change, there is high uncertainty around the forecast of industrial inflation this year. We continue to expect headline inflation to moderate by the end of the year, driven by favorable effects in energy prices, and reverting to below the ECB target at the beginning of 2012. Regarding core inflation, we expect it to hover around 1.8% for the remainder of 2011, moderating somewhat afterwards. **Market Impact:** Although the acceleration of inflation in September should be temporary, it could surprise markets, and thus increase concerns that ECB monetary policy may return to a more hawkish tone.

Eurozone: Unemployment rate (August, September 30th)

Forecast: 10.0%;	Consensus: 10.0%;	Previous: 10.0%;

Comment: We expect the unemployment rate to remain stable in August, as observed since the beginning of the year. Nevertheless, increasing uncertainty about the economic outlook in coming quarters combined with disappointing activity data for Q2 and Q3 have weighed on hiring intentions, which worsened in July and August according to the EC survey, and therefore the risks to unemployment are on the upside for coming months. **Market impact:** Given the lag between growth and employment, we do not anticipate major changes in unemployment, although a worse than expected outcome would increase the concerns of a return to recession.

Gross Domestic Product, Final (2Q11, September 29th)

Forecast: 1.2%	Consensus: 1.2%	Previous: 1.0%

Comment: The final estimate for 2Q11 GDP is expected to be slightly higher than the preliminary figure. Although not much new data for Q2 was released since the last report, business inventories and durable goods orders were revised upward for June. Furthermore, the international trade balance was revised up, from -$53.1bn to -$51.6bn, mostly due to a reduction in imports. While economic activity has remained sluggish, we expect Q2 GDP to remain in line with our baseline scenario for modest growth in 2011. **Market Impact:** Markets are not overly concerned with the final GDP estimate for the second quarter given that much of the relevant data has already been released. However, increasing uncertainties regarding the future outlook have caused markets to become very sensitive to worse-than-expected economic reports.

Personal Income and Outlays (August, September 29th)

Forecast: 0.1%, 0.1%	Consensus: 0.1%, 0.2%	Previous: 0.3%, 0.8%

Comment: Personal income and outlays are expected to grow in August but at a slower MoM pace. Weak employment conditions continue to weigh on personal income, with the August report indicating no job growth and a reduction in average earnings. Continued declines in consumer confidence and flat retail sales for the month suggest conservative spending, particularly after July's surprising jump. Although higher food and energy prices may have contributed to growth in nominal terms, we expect real growth to be minimal. **Market Impact:** Modest growth in personal income and spending will warrant little reaction from markets, although better-than-expected reports could signal a much-needed boost in consumer demand and activity.

China: PMI for (September, October 1st)

Forecast: 51.6	Consensus: n.a.	Previous: 50.9

Comment: Activity indicators have held up well so far, in line with our expected soft landing scenario. However, with downside risks to global demand increasing, markets will be watching the forthcoming monthly Purchasing Managers' Index (PMI) for signs of a more significant slowdown. A flash estimate of the private sector PMI for September (Markit) suggests some weakening of manufacturing sentiment. Nevertheless, with recent activity data continuing to show strength, we expect the official PMI for September to increase from last month, although this mainly reflects seasonality (despite the statistic agency's efforts to de-seasonalize the series). **Market impact:** A lower-than-expected reading, especially a decline from the previous month or an outturn below the 50+ expansion threshold, could dent sentiment about the growth outlook.

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			Close	Weekly change	Monthly change	Annual change
Interest Rates (changes in bps)	US	3-month Libor rate	0.36	1	5	7
		2-yr yield	0.21	5	-2	-23
		10-yr yield	1.77	-27	-53	-83
	EMU	3-month Euribor rate	1.54	0	0	66
		2-yr yield	0.37	-15	-35	-36
		10-yr yield	1.73	-14	-48	-62
Exchange Rates (changes in %)	Europe	Dollar-Euro	1.351	-2.1	-6.3	0.2
		Pound-Euro	0.87	0.1	-0.5	2.7
		Swiss Franc-Euro	1.22	1.3	6.8	-7.8
	America	Argentina (peso-dollar)	4.20	0.0	0.4	6.2
		Brazil (real-dollar)	1.88	9.9	17.1	9.9
		Colombia (peso-dollar)	1903	4.5	6.2	5.3
		Chile (peso-dollar)	518	7.9	11.0	6.5
		Mexico (peso-dollar)	13.83	6.7	11.3	10.2
		Peru (Nuevo sol-dollar)	2.79	2.0	2.0	0.0
	Asia	Japan (Yen-Dollar)	76.27	-0.8	-0.7	-9.6
		Korea (KRW-Dollar)	1165.70	4.8	7.5	1.4
		Australia (AUD-Dollar)	0.979	-5.6	-6.5	2.2
Comm. (chg %)		Brent oil ($/b)	105.1	-6.4	-4.6	33.2
		Gold ($/ounce)	1673.6	-7.6	-4.9	29.1
		Base metals	547.9	-3.6	-3.1	4.2
Stock Markets (changes in %)	Euro	Ibex 35	7845	-6.5	-6.3	-26.9
		EuroStoxx 50	1980	-8.3	-11.6	-29.1
	America	USA (S&P 500)	1130	-7.1	-4.0	-1.6
		Argentina (Merval)	2487	-9.6	-14.5	-3.5
		Brazil (Bovespa)	53315	-6.8	-0.9	-21.8
		Colombia (IGBC)	13149	-5.3	-1.5	-6.9
		Chile (IGPA)	18625	-4.5	-6.7	-15.9
		Mexico (CPI)	32429	-7.8	-6.4	-2.6
		Peru (General Lima)	19003	-7.6	-2.6	9.7
		Venezuela (IBC)	100714	0.3	1.0	52.4
	Asia	Nikkei225	8560	-3.4	-0.9	-9.6
		HSI	17669	-9.2	-9.2	-20.1
Credit (changes in bps)	Ind.	Itraxx Main	199	23	27	86
		Itraxx Xover	845	131	128	329
	Sovereign risk	CDS Germany	106	23	21	66
		CDS Portugal	1179	124	141	777
		CDS Spain	437	66	61	212
		CDS USA	56	6	8	---
		CDS Emerging	369	78	66	138
		CDS Argentina	1044	181	214	280
		CDS Brazil	218	58	56	101
		CDS Colombia	213	53	53	90
		CDS Chile	151	37	45	74
		CDS Mexico	214	55	53	82
		CDS Peru	219	54	51	100

Source: Bloomberg and Datastream

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