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Weekly Watch

Global

Madrid, 24 June 2011

Economic Analysis

Financial Scenarios
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Price pressures remain elevated in Asia

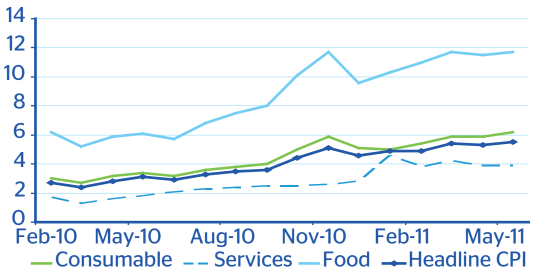
The remark from China's premier about the authorities' success in battling inflation has prompted market expectations for an ease in China's tightening cycle. Although inflation may soon peak in China, price pressure remains high. Thus, we think that there are more interest rate hikes and other tightening measures to come in 2H11. In developed countries, recent economic indicators underscored the slowdown of the global economic cycle. In the eurozone, the PMI Composite index has declined more than expected in June, driven mainly by the manufacturing component (see highlight). In the US May existing home sales and new home sales continued to highlight the weakness of the US housing market (see our 20 May Global Weekly), while unemployment data has continued to disappoint market expectations. The Fed has confirmed that the weakness seen in recent economic data is temporary. The rebound in the May durable goods order suggested that the US economy is improving after being negatively affected by the Japanese earthquake. Nevertheless the FOMC's statement was relatively dovish (see highlight).

Additional EU aid to Greece with private sector involvement, but pending on Greek parliament decision

The conclusion of the European council meeting on 24 June confirmed some of the agreement achieved in the previous ECOFIN meeting. The EU favours a second aid packaged to Greece, subject to the Greek parliament approving the medium-term fiscal strategy (MTFS), expected for next week. The statement also stipulated that additional funding will also come from private sources in the form of voluntary roll-overs when the Greek debt matures. The final decision is expected to be taken by early July. One of the main risks in this scenario is the possible action which may be taken by rating agencies and the ECB's liquidity provision rules. There are some initial signs they are starting to move towards a consensus, for example Fitch said that under a Vienna-type initiative for Greece, it would temporarily downgrade Greece's 'Issuer Default Rating' to 'restricted default' but keep the government bonds at 'CCC', which would enable Greek debt to be eligible for collateral to discount into the ECB.

Next Week: China June PMI index will be closely watched, in addition to the June US ISM index and the eurozone June IPC.

Chart 1
Chinese inflation will peak but price pressure remains



Source: Bloomberg

Chart 2
The US durable orders have rebounded in May

Source: Bloomberg

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FOMC: sleeping with one eye open

FFOMC will wait for definitive proof that a recovery is sustainable before an exit.

The eurozone PMI composite decreased more than expected

We expect the EZ GDP to growth +0.3% q/q for the rest of the year, clearly below the consensus.

The IMF strongly supported the Spanish government's policies

Nonetheless the Fund said that further reforms that strengthen commitments to fiscal targets should be pursued.

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Markets

Breathing space for Greece, but for how long?

Papandreou won Tuesday's confidence vote in the Greek parliament, one of the conditions setby the EU in order to continue providing the country with financial aid. Initially, this may triggersome easing in risk premiums from recent tight levels. Nevertheless, we must highlight the factthat this outcome was clearly the opposite of what was expected: the impact would have beena lot greater if Papandreou had not won the vote of confidence given that the risk premiumswould have then depended on subsequent actions. The next step for Greece now is to approveEUR78bn of austerity measures next week, a crucial step if it is to get the next tranche of itsbailout loan, which up until now had been put on ice. The easing should be more intense andespecially apparent: i) at the short ends of the euro curve (which had reacted most on thedownside) potentially restoring sensitivity to the ECB rate cycle; ii) core/non-core spreads whichhave been highly influenced over the last few days by the contagion effect; and iii) asset swaps(difference between the Govt. and swap curve) which should correct, reflecting the drop in therisk premium. In any event, we see all of these attempted rebounds as limited in scope.

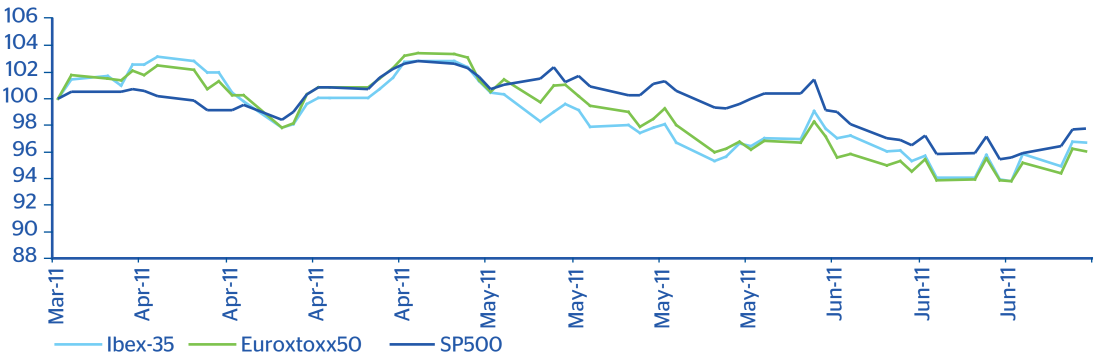
EURUSD falls after FOMC

The FX space continues to remain glued to the Greek / European peripheral debt story, withsome splices of Fed drama in-between. Wednesday's FOMC statement underscored BBVA's viewof ultra-loose rates for longer which in this point of the economic cycle and recovery shouldhave negative connotations for the USD. Bernanke's subsequent press conference seemed todownplay the notion of a so-called "QE3" program and it appears FX markets have been mostfixated with this notion in the hours after the statement and Bernanke commentary. We aresomewhat surprised to see EURUSD more than two big-figures lower versus spot from whenthe FOMC statement was released Thursday; we did not perceive the statement and pressconference to be overly USD hawkish or the market to be half-expecting announcements ofadditional liquidity injections. We believe any positive USD reaction to FOMC will beshort-lived as the market rotates back towards other key themes and drivers Greek headlines(where we expect a positive outcome) and the US economic data flow.

Extreme volatility in credit markets

Credit markets are faced with extreme volatility ahead of the solution to Greece's crisis. Syntheticindexes across the board have widened this week after starting out tighter; the iTraxx Main by4bp to 114bp since Friday's close and the iTraxx SovX by 12bp to a new all-time high of 236bp.In financials, the iTraxx Financial Senior and Subordinated have widened by 7bp and 8bp,respectively, to 163bp and 290bp.Financials are still finding it virtually impossible to tap the primary market, although there hasbeen some activity among corporates. BAA, the UK airport operator, issued USD1bn of 10-yearbonds. RCI came to market with a EUR500mn issue, also of 10-year bonds, paying ms+160, whilethe European Financial Stability Facility issued EUR3bn of 5-year bonds at ms+6bp in a bid to helpfund Portugal's bailout.Turning to the secondary market, investors remain leery ahead of the solution to Greece's crisis.Market volatility is high and, despite myriad trading opportunities, liquidity is thin. There is agreat deal of uncertainty at present, mainly surrounding poor US macro readings and concernsover the situation in Greece. That said, if we forget about Greece for a moment, there are somemedium- and long-term factors that bode well for credit: i) compelling spreads, ii) low gearingamong corporate and iii) recapitalisation and balance sheet strengthening among financialinstitutions. What's more, investors have built up strong cash positions that, if used, could triggerspread tightening.

Chart 3
Accumulated performance of Ibex-35, Eurostoxx50 and S&P500



Source: Bloomberg

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Highlights

FOMC: Sleeping with one aye open

The statement from the last FOMC meeting described the economy as displaying moderate growth, but a pace somewhat slower than previously expected. It believes that the weakness in economic indicators is a passing phenomenon, and the result of the spike in oil prices and the natural disaster in Japan. On the inflation side, FOMC maintains that the recent uptick in inflation is the result of a temporary increase in commodity prices. Nevertheless, the Fed believes that there are also long-term factors behind the US slowdown related to the financial crisis, particularly bank and household deleverage, and fiscal consolidation. Regarding monetary policy, Bernanke said that it would be useful to wait a little longer before making any policy decisions. If the weakness in the economy was to continue, the Fed may employ additional tools. As a result, we have shifted the cessation of reinvestment of principal to November, but the rest of our sequencing remains the same and we still expect a first rate hike in March 2012. We currently foresee risks tilted to the downside, suggesting that the first rate hike will be postponed if the economy slows considerably.

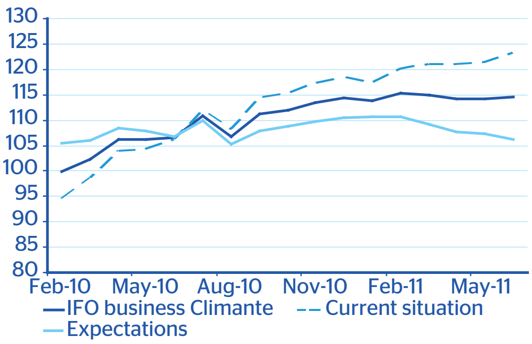
The eurozone PMI composite decreased more than expected

There was a sharp deceleration in eurozone PMI indicators in June, with the composite index falling by 2.1 points to 53.6, due to a slowdown in both manufacturing (-2.6p to 52.0) and services (-1.8 to -54.2). The figures were well below our own expectations and those of the consensus of a softer deceleration, after two months of still relatively upbeat activity. In Germany, the sudden drop came from the manufacturing sector, while the service sector improved, while in France the decline affected both sectors. According to Markit, outside these countries, activity actually contracted in June (PMI below 50).This slowdown is broadly consistent with our projected deceleration for 2Q, after +0.8% q/q in 1Q. Our MICA model suggests that growth could be 0.4% quarterly, while considering just PMIs, Markit suggests that growth would be 0.6% and slowing. However, the steepness of the fall, along with the contraction in the periphery, does increase market uncertainty regarding the recovery over the coming months. Our scenario included a slowdown to +0.3% q/q for the rest of the year, clearly below the consensus, on account of the oil price hike and the reversion of the temporary factors that boosted activity in 1Q. This week's PMI numbers suggest that we are moving towards such a scenario, but there are downward risks surrounding global activity that may have more permanent effects on the eurozone.

The IMF strongly supported the Spanish government's policies

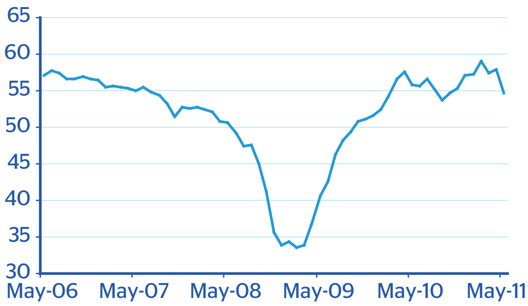
The IMF strongly supported government policies implemented over the last year in Spain. The Fund expects growth to remain weak over the short term, and to eventually move somewhere between 1.5% and 2% per year (a little below our own estimate, at around 2%). Nonetheless, according to their view, risks remain biased to the downside and Spain should pursue further reforms which: strengthen commitments to fiscal targets; lead to a decisive implementation of the strategy envisaged for recapitalizing part of the financial sector; and that deepen and broaden the reforms implemented so far. Most of the improvements suggested by the Fund are in line with our own view expressed in recent (Spain Economic Outlook, May 2011) and not so recent (Spain Economic Outlook, March 2009) publications. Some of these include: i) the creation of an independent fiscal council; ii) the implementation of strong fiscal rules; iii) the recapitalization of part of the financial system that favours private sector participation while limiting the stay of public funds when needed; iv) greater transparency; v) a bolder labour market reform that further lowers severance payments and allows wages to adjust to firm specific conditions; and vi) fostering competition in non-tradable sectors.

Chart 3
German IFO unexpectedly increased in June



Source: Bloomberg

Chart 4
Eurozone Manufacturing PMI



Source: Bloomberg

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Calendar: Indicators

Eurozone: HICP inflation (June, June 30th)

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

Comment: after seasonal effects in previous months, we expect headline inflation to have increased slightly by 0.1pp to 2.8% y/y in June, reversing last month's decline. Fuel prices in recent weeks have continued to ease, putting some downward pressure on our forecasts, nonetheless we think they should be partly offset by upward risks coming from higher indirect effects. The detailed breakdown will not be released next week, but our projections show that core inflation could have also risen slightly to 1.9% y/y. **Market Impact:** a further acceleration in core inflation could increase market concerns about higher indirect effects that could result in tighter monetary policy.

Eurozone: Money Supply (May, June 30th)

Forecast: : 2.1% y/y	Consensus: 2.2% y/y	Previous: 2.0% y/y

Comment: Eurozone lending data for May are expected to reflect a still sluggish credit performance. M3 is expected to keep growing in May, following its slow growth trend of the last few months, after the surprise registered in February. Across its counterparts, loans to households are expected to have increased further, albeit at a more modest pace than that observed at the beginning of the year. Loans to non-financial corporations are likely to continue at its subdued pace, after the rebound observed in January and February. **Market impact:** better than expected outcomes could be received as a sign that credit is recovering, but also can be read as a trigger for a tighter stance by the ECB.

US: Personal Income and Spending (May, June 29th)

Forecast: 0.4%, 0.2% m/m	Consensus: 0.4%, 0.1% m/m	Previous: 0.4%, 0.4% m/m

Comment: Preliminary estimates for April indicate personal income, disposable personal income, and personal consumption expenditures increased 0.4%, 0.3%, and 0.4% m/m, respectively. In real terms, DPI was unchanged while PCE increased only 0.1% m/m. The revised March estimates were comparable to the preliminary April release, but with no real DPI growth and only slight real m/m Personal Consumption growth. We expect both DPI and PCE to maintain their current low growth trajectory. In addition, we expect stable price growth in next month's release. **Market Impact:** real increases to DPI or PCE would indicate consumer demand is not as weak as recently thought. Equity markets should react positively to strong consumption numbers.

US: ISM Manufacturing Index (June, July 1st)

Forecast: 52.5	Consensus: 52.0	Previous: 53.5

Comment: the ISM Manufacturing index shows expansion in manufacturing activity for the twenty-second consecutive month, with 14 out of 18 manufacturing sectors reporting growth in May. The diffusion survey registered 53.5, which is above the 50 point benchmark indicator of manufacturing growth. However, new orders dropped 17.3% m/m to 51.0, sliding below the 52.1 threshold (consistent with an increase in the Census Bureau's series on manufacturing orders), indicating a possible slowdown. Alternatively, prices were down 9pp m/m. Overall, respondents indicated that activity remains strong but some respondents noted the possibility of a softening in the 2H11. **Market Impact:** if the manufacturing report is below consensus estimates, we expect markets to decline in anticipation of slow growth in July.

China: PMI (June, July 1st)

Forecast: 51.6	Consensus: 51.5	Previous: 52.0

Comment: we expect the Purchasing Managers' Index (PMI) to ease for a third consecutive month in June as economic activity continues to moderate on the authorities' monetary tightening measures. Nevertheless, the outturn should remain well within the +50 expansion zone, allaying concerns of a hard landing. **Market impact:** a lower-than-expected reading could exacerbate worries of a hard landing, while the opposite would intensify expectations of further monetary tightening.

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			Close	Weekly change	Monthly change	Annual change
Interest Rates (changes in bps)	US	3-month Libor rate	0.25	0	-1	-29
		2-yr yield	0.35	-3	-19	-30
		10-yr yield	2.93	-2	-20	-18
	EMU	3-month Euribor rate	1.53	2	9	78
		2-yr yield	1.39	-12	-27	83
		10-yr yield	2.88	-8	-17	27
Exchange Rates (changes in %)	Europe	Dollar-Euro	1.420	-0.6	0.7	15.0
		Pound-Euro	0.89	0.6	2.7	8.0
		Swiss Franc-Euro	1.19	-1.6	-3.1	-11.8
	America	Argentina (peso-dollar)	4.10	0.0	0.3	4.2
		Brazil (real-dollar)	1.59	-0.4	-2.2	-10.4
		Colombia (peso-dollar)	1787	0.0	-2.3	-5.9
		Chile (peso-dollar)	474	0.6	0.6	-11.7
		Mexico (peso-dollar)	11.88	-0.4	1.6	-6.4
		Peru (Nuevo sol-dollar)	2.76	-0.1	0.4	-2.4
	Asia	Japan (Yen-Dollar)	80.60	0.5	-1.7	-9.8
		Korea (KRW-Dollar)	1082.50	-0.5	-1.7	-10.5
		Australia (AUD-Dollar)	1.051	-0.9	-0.2	20.7
Comm. (chg %)		Brent oil ($/b)	107.0	-5.5	-6.9	37.0
		Gold ($/ounce)	1517.9	-1.4	-0.5	20.9
		Base metals	595.6	-1.0	-1.8	23.4
Stock Markets (changes in %)	Euro	Ibex 35	10033	-1.0	-1.8	5.2
		EuroStoxx 50	2767	-0.1	-1.8	5.3
	America	USA (S&P 500)	1284	0.9	-2.8	19.2
		Argentina (Merval)	3314	1.4	1.0	43.0
		Brazil (Bovespa)	61194	0.2	-3.5	-5.6
		Colombia (IGBC)	14215	1.3	0.2	13.5
		Chile (IGPA)	22202	1.1	-2.4	16.4
		Mexico (CPI)	35327	0.9	-0.5	8.3
		Peru (General Lima)	19014	-4.4	-13.6	33.9
		Venezuela (IBC)	80159	-0.9	0.1	23.1
	Asia	Nikkei225	9679	3.5	2.7	-0.6
		HSI	22140	2.1	-2.7	7.0
Credit (changes in bps)	Ind.	Itraxx Main	116	5	13	-11
		Itraxx Xover	426	17	55	-123
	Sovereign risk	CDS Germany	45	5	5	0
		CDS Portugal	827	36	159	503
		CDS Spain	294	5	38	43
		CDS USA	53	2	4	---
		CDS Emerging	233	2	20	-23
		CDS Argentina	641	11	36	-326
		CDS Brazil	118	2	13	-13
		CDS Colombia	114	3	12	-35
		CDS Chile	78	3	9	-21
		CDS Mexico	115	3	12	-13
		CDS Peru	150	0	22	22

Source: Bloomberg and Datastream

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