Global

Weekly Watch

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Economic Analysis

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An unavoidable but short Euro agreement

The EU Council summit of 24-25 March has confirmed the key decisions taken at previous meetings to create a permanent rescue fund (ESM) with an effective lending capacity of €500 bn, and allows it to buy bonds in the primary market under strict conditionality. Perhaps the door has been opened to more flexibility than expected, although it is not clear how this could be used (see highlight). The framework for prevention of future crises seems robust, but the EU seems to have avoided directly confronting the solvency issue which is at the heart of the current crisis.

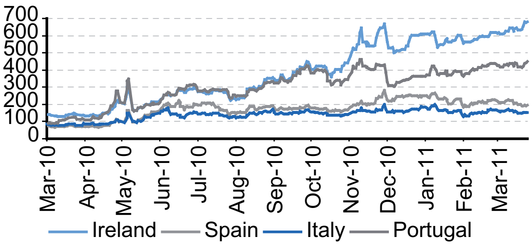
The resignation of the Portuguese Prime Minister, after Portugal's parliament rejected the new austerity measures presented by the government, raises uncertainty on the Portuguese Economy (see highlight); but Portugal fears have not affected European assets or Spanish contagion.

Tightening goes ahead

Despite the recent problems in Portugal, the Japanese tragedy and the geopolitical risk in MENA countries, the ECB is continuing with its hawkish tone, suggesting it will hike interest rates at its next meeting. Similarly, China has increased its reserve requirement ratio again, suggesting a tighter monetary policy than expected (see highlight).

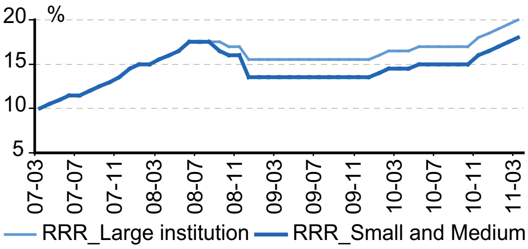
On the economic side, the Eurozone PMI index for March was in line with expectations, but moderating slightly after record-high levels observed in previous months. The March data was probably negatively affected by recent events such as the spike in oil prices or the increase in expectations of the ECB rate hike in April. Meanwhile, in the US jobless claims showed further improvement in the US labor market. Next week: the Eurozone March CPI and the US March payroll will be the main focus of the market.

Chart 1
Sovereign Spreads: 10yr Bond (bps)



Source: Bloomberg

Chart 2
China Hikes the RRR for the 3rd Time this Year



Source: Bloomberg

Highlights

Portugal closer to a rescue, contagion to Spain unlikely
The resignation of PM Socrates raises uncertainty on the Portuguese economy.

China hikes the RRR yet again to withdraw liquidity
The third hike in the RRR so far this year marks an aggressive tightening campaign.

Implications of a Second Homeland Investment Act
The HIA will generate $600bn in flows, which would largely go to dividends and buybacks.

Agreement on the structure of the ESM mechanism
The effective lending capacity of the ESM will be €500bn.

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Logically counterintuitive equity markets

As on other occasions, equity markets are doing the opposite to what they might initially be expected to do. Portugal is on the verge of a bailout, but all of the European equity markets have risen, including Portugal's. If we look at the situation in more detail, the positive reaction makes more sense: 1) this is no surprise and would be a manageable amount at a European level; 2) the key to sovereign and systemic risk in Europe is Spain and we insist on our view that the country is solvent; 3) the European rescue funds are being extended; 4) the Pact for the Euro heads in the right direction, i.e. improving the economic outlook, but it can be improved; 5) the world moves to the rhythm of emerging markets, and if they continue to grow, equity markets will price this in; 6) following weeks of uncertainty over Japan and Libya, some appetite for risk has again appeared in speculative assets such as commodity-linked currencies (the Australian dollar is heading towards new highs vs. the US dollar) and commodities that are most strongly linked to the cycle such as copper and nickel; 7) US companies are set to repatriate USD600bn in earnings from subsidiaries, which should make it clear that there is enough money to raise dividends, buy back shares, step up investment or get involved in M&A, and; 8) equity markets are quite simply cheap, because in our view forecast earnings are robust (P/E 11e S&P 500 13.5x, EuroStoxx 50 9.9x e Ibex 35 10.8x).

Portuguese risk favours our bias towards flattening

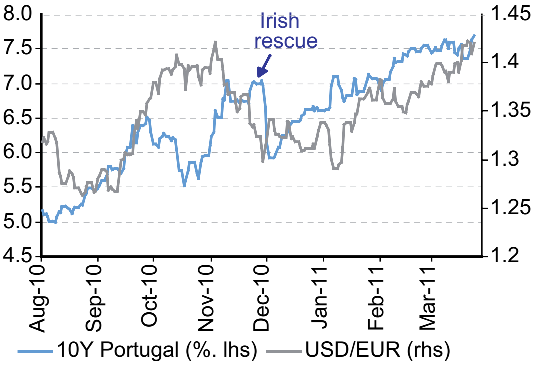
In the coming days the short end of the euro curve should continue to move within a limited range: although yields have risen recently towards the highs seen in early March due to the reinforced prospect of a hawkish ECB from April, they do not seem to have the momentum to breach these levels. In addition, the long ends may have some room on the downside as a result of the effect the Portuguese crisis may have on safe haven assets. This risk has meant that the German 10Y has found some underlying demand as seen at the last auction, which hit highs not seen since 2002 (bid-to-cover of 2.2X). This downward trend in the 10Y (and decoupling with the 2Y) may become accentuated in the short term as news emerges regarding Portugal, still favouring our bet on a bias towards flattening in the 2/10Y curve.

Ratings downgrades are all around

Political uncertainty and the rating downgrades by S&P and Fitch in Portugal have hardly had any impact on the 5Y CDS of the Portuguese entities with the best credit metrics. It is important to note that Portuguese bank's credit and solvency profiles are very different to their Irish counterparts'. Portuguese banks have limited exposure to real estate and there has been no real estate bubble in the country. Nonetheless, the greatest challenge that Portuguese entities face is difficulty in obtaining wholesale funding as a result of sovereign risk, making some entities highly dependent on the ECB.

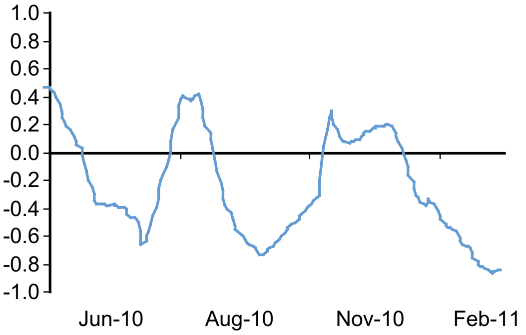
In the case of Spain, Moody's downgraded the rating on the senior debt of 30 Spanish entities, two of which by four notches, maintaining its negative outlook. This downgrade is not merely a result of the previous downgrade of Spain's sovereign bonds to Aa2, but also of a change of methodology at Moody's. The agency has recalculated future systemic support for senior debt issued by smaller entities, since it believes that they are unlikely to be rescued by the sovereign authorities..

Chart 3
Performance of USD/EUR and 10Y Portuguese Bond



Source: Bloomberg

Chart 4
Correlation* between Euro 2/10 Govt Slope and 10Y Portugal-Germany Spread



*60 days rolling
Source: Bloomberg and BBVA Research

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Highlights

Portugal closer to a rescue, contagion to Spain unlikely

The resignation of PM Socrates raises uncertainty on the Portuguese economy. Early elections are very likely. Despite the talk of a grand coalition government in recent days, this scenario is highly unlikely, especially considering that political considerations, rather than disagreements on economic policy targets or measures, led to the PM's resignation. The baseline political scenario is of elections in early-mid June. The main opposition party PSD clearly leads the polls. On the financial side, it is clear that higher uncertainty could put more pressure on Portuguese spreads, reducing the availability of funds and increasing the probability that Portugal will have to ask for financial help. Even if Portugal is forced to ask for a rescue in the short term, it is difficult to see how the conditionality attached to it would be agreed between the main parties, and accepted by the EU at a time when large EU countries want to reinforce conditionality. Hence, even if Portugal is forced to go to the ESFS ahead of the elections there are technical and political hurdles to be overcome, and the Portuguese debt maturity calendar is challenging in the short term. The Portuguese Treasury faces €12.4 bn between April and June 2011. According to our estimates, Portugal is funded until mid-June, which implies that in any case it will need additional funding ahead of the formation of a new government, if there is no demand in coming auctions. We estimate the amount of Portugal's potential bail-out to be around €80 bn. The contagion to Spain through trade flows will be negative but limited (see or G. Weekly January 14th). Also, the Spanish financial system's total exposure to Portugal is limited, equivalent to 2% of Spanish banking assets. In any case, the financial channel should be the most important, in that way Spain has to reinforce its commitment with structural reforms. In this regard Spain has been one of the few countries to announce specific commitments at the EU Council summit.

China hikes the RRR yet again to withdraw liquidity

China's central bank announced another 50 bps hike in the required reserve ratio (RRR) on March 18th. This marks the third hike in 2011, on top of six hikes in 2010, and is the latest move by the PBOC to tighten liquidity and contain rising inflationary pressures. It is expected to drain around RMB 360 billion from the banking system, on top of complementary open market operations expected to drain an additional RMB 103 billion. The RRR for large banks now stands at a record 20% while the ratio for small banks stands at 18%. The move comes amidst evidence of strong capital inflows (Jan-Feb FDI inflows were up by 27.0% y/y), suggesting that the capital inflow is regaining its strong momentum and, as a result, adding extra liquidity into the banking system, despite a recent narrowing of the trade surplus. The latest hike means that monetary policy has been tightened more aggressively than previously expected, in response to rising inflationary pressures. Nevertheless, the growth outlook appears intact, with the tightening measures coming on top of stronger than expected momentum. We now anticipate additional RRR hikes amounting to 100-200 bps this year. On interest rate hikes, we maintain our previous projection of two more 25 bps hikes by end-year.

Implications of a Second Homeland Investment Act

The Homeland Investment Act (HIA) is a renewed program to allow repatriation of foreign profit back to the US at a favourable rate. The revival of the program has come up in the context of broader corporate tax reform in the US. From a political standpoint, Obama administration officials are unlikely to approve this tax break without including it within a more comprehensive tax overhaul. Back in 2005 most repatriation went to share buybacks and dividends to shareholders. The investment in training, plant and equipment did not materialize, and proponents of the tax break do not expect a different outcome. The HIA will generate $600bn in flows, which would largely go to dividends and buybacks. Another likely use of funds will be for merger activity, which may speed up industrial restructuring in the US or accelerate industrial concentration. Repatriated profits, given their bent towards share purchases, would be akin to QE3. Given the rapid recovery in major stock indices, the marginal benefit of more wealth effects is likely to be small and may instead increase vulnerabilities in the financial system. Additionally, dividend income is highly centred in the top quintile while the spending elasticity tends to be lower than most other income sources. The inflows will be bullish for the dollar, but other factors will pull against this currency, such as: inflation pressures and the fiscal situation.

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Agreement on the structure of the ESM mechanism

The EU Council agreed on the structure of the European Stability Mechanism (ESM). It will have a total capital base of €700bn, of which €620bn will be callable capital and guarantees and €80bn will be paid-in capital, which will be paid during five years, instead of three years, starting in 2013. But to ensure the ESM will achieve the maximum credit rating, member states are committed to accelerate the provision of appropriate instruments in order to maintain the minimum of the 15% ratio between of paid-in capital and the outstanding amount of ESM issuances if needed. The ESM will have preferred creditor status, although the IMF's preferred credit status will be higher than that of the ESM. The ESM will have an effective lending capacity of €500 bn. The price margin of the ESM will be lower than the current EFSF (see velow table) and the pricing structure of the ESM will also be reviewed periodically, reducing the risk of debt restructuring. The ESM will provide loans, but in exceptional circumstances it can also purchase debt in the primary market, subject to a strict plan. However the Board of Governors may review the instruments at the ESM's disposal and may decided to make changes to the menu of instruments. This opens the door to credit lien or to purchase debt in the secondary market, among other instruments. Nevertheless, to access the ESM a debt sustainability assessment will be required. Finally, the EU council estimates that the increase of the EFSF effective lending capacity to €440bn will be ready in June. In all, we are far from an ideal governance framework: liquidity problems are partially solved, but the threat of debt restructuring remains.

Table 1
Main Differences between the Current EFSF and the Permanent ESM

	EFSF	ESM
To be in forces	Until June 2013	From June 2013
Capital base (include guarantees)	440,000	700,000
Guarantees or callable capital	440,000	620,000
Cash Capital	0	80,000
Cash Buffer*	111,000	---
Effective lending capacity (current)**	255,000	500,000
Cost of loan (current) bps up to 3Y bp***	300	200
extra cost for loan longer than 3Y (bp)	100 per year	100
Access to the Fund	Conditionality	Debt sustainability assessment will be required
Instruments	Loan	Loan
Exception: subject to a strict plan	To purchase debt in primary market	To purchase debt in primary market
Credit Status	No preferred credit status	Preferred credit status
Credit Rating	AAA	AAA Expected

* Cash buffer= ((total guarantees/1.2)-(total triple A guaranties * 1.2)).
**in EFSF Lending capacity= Amount of Triple A countries * 1.2.
*** The pricing structure of the ESM funding will be reviewed periodically.
Source: EU Council and BBVA Research

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Calendar: Indicators

Eurozone: Flash HICP inflation (March, March 31st)

Forecast: 2.5% y/y	**Consensus:** 2.3% y/y	**Previous:** 2.4% y/y

Comment: We expect headline inflation to accelerate slightly to 2.5% in March, from 2.4% y/y in February. Although the detailed breakdown will not be released next week, our projections show that core inflation could have increased again to 1.2% y/y, driven by an expected rebound in the prices of non-energy industrial goods, after the end of winter sales. Processed food prices are likely to have increased further, while service inflation should have remained broadly stable. In addition, recent fuel prices available for March suggest that energy prices should have increased further, but at a more moderate pace. **Market Impact:** A further acceleration in core inflation could increase market concerns about tighter ECB monetary policy in order to face second round effects.

Eurozone: Unemployment (February, April 1st)

Forecast: 9.9%	**Consensus:** 9.9%	**Previous:** 9.9%

Comment: The unemployment rate is expected to have remained stable in February, after declining in the previous month. Although economic activity could have gained momentum in Q1, we still do not see a sustained drop in the unemployment rate. However, soft data showed that hiring intentions have improved slightly in recent months, but they might be dampened by increased uncertainty about the economic outlook in coming quarters, resulting from the negative impact of interest rate hikes, as well as higher oil prices. **Market impact:** No major surprises are expected. A negative surprise would be interpreted as a sign of renewed downward pressure on economic activity.

Non-farm Payrolls (March, April 1st)

Forecast: 195K	**Consensus:** 190K	**Previous:** 192K

Comment: In the last three months, the unemployment rate declined unexpectedly from 9.8% to 8.9%, which is the lowest level since March 2009. However, the sharp decline in the unemployment rate was mainly due to decline in the labour force participation rate. In February, it was at 64.2% which is the lowest level since March 1984. Last month, total non-farm payroll rose 192K while the private sector created 222K new jobs. In other words, the government sector lost 30K jobs and continued to drag the labour market. Regional and local governments are in vulnerable fiscal conditions and therefore, we do not expect significant employment growth in the government sector. However, the latest initial and continuing jobless claims indicate that labour market conditions are improving. We expect the private sector to continue creating new jobs but the unemployment rate looks set to remain at 8.9%. **Market impact:** If the private sector creates more than 250K new jobs in March, it would imply a strong labour market and robust economic activity. Therefore, it would increase optimism in the financial markets.

ISM (March, April 1st)

Forecast: 62.5	**Consensus:** 61.0	**Previous:** 61.4

Comment: The Institute for Supply Management (ISM) manufacturing Index, a leading indicator for economic activity, is expected to increase in March. An index number greater than 50 indicates expansion in the manufacturing industry in the related month. The ISM manufacturing index has been above 50 since August 2009. The latest report indicates that prices are increasing significantly and inventories have started to decline in the manufacturing sector. **Market impact:** If the ISM index increases significantly, it would indicate strong economic growth in 1Q11 and push equity prices higher.

China: PMI (March, April 1st)

Forecast: 55.5	**Consensus:** 54.5	**Previous:** 52.2

Comment: The Purchasing Managers' Index (PMI) is expected to increase from February's moderating outturn, which was partly the result of seasonality from the Chinese New Year. Economic momentum remains strong despite the monetary tightening measures implemented in first quarter. **Market impact:** A higher-than-expected reading might fuel expectations of further tightening measures.

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				Close	Weekly change	Monthly change	Annual change
Interest Rates	(changes in bps)	US	3-month Libor rate	0.31	0	0	2
			2-yr yield	0.69	11	-5	-35
			10-yr yield	3.40	13	-9	-45
		EMU	3-month Euribor rate	1.20	3	12	57
			2-yr yield	1.72	9	17	72
			10-yr yield	3.27	8	13	12
Exchange Rates	(changes in %)	Europe	Dollar-Euro	1.414	-0.2	2.9	5.6
			Pound-Euro	0.88	0.8	3.7	-2.2
			Swiss Franc-Euro	1.29	1.3	0.9	-9.4
		America	Argentina (peso-dollar)	4.04	0.1	0.3	4.6
			Brazil (real-dollar)	1.66	-0.7	-1.0	-9.3
			Colombia (peso-dollar)	1870	-0.2	-1.5	-3.5
			Chile (peso-dollar)	480	-0.6	0.9	-9.8
			Mexico (peso-dollar)	11.95	-0.9	-2.1	-4.7
			Peru (Nuevo sol-dollar)	2.79	0.7	-0.1	-1.9
		Asia	Japan (Yen-Dollar)	81.18	0.4	-1.5	-12.3
			Korea (KRW-Dollar)	1111.55	-1.3	-1.6	-2.7
			Australia (AUD-Dollar)	1.027	3.0	2.7	14.0
Comm.	(chg %)		Brent oil ($/b)	115.8	1.6	4.1	46.0
			Gold ($/ounce)	1436.7	1.3	1.8	29.7
			Base metals	626.6	1.4	1.9	24.9
Stock Markets	(changes in %)	Euro	Ibex 35	10726	3.9	0.9	-3.1
			EuroStoxx 50	2910	4.2	-1.5	-1.1
		America	USA (S&P 500)	1315	2.8	0.6	12.7
			Argentina (Merval)	3349	2.2	-2.3	39.4
			Brazil (Bovespa)	68076	1.8	1.7	-0.9
			Colombia (IGBC)	14658	0.1	0.4	22.5
			Chile (IGPA)	21750	5.3	5.4	23.7
			Mexico (CPI)	36908	4.2	1.2	11.3
			Peru (General Lima)	22570	10.1	-0.2	50.7
			Venezuela (IBC)	71588	2.5	5.6	22.7
		Asia	Nikkei225	9536	3.6	-9.9	-13.3
			HSI	23159	3.8	1.1	10.0
Credit	(changes in bps)	Ind.	Itraxx Main	101	2	-1	23
			Itraxx Xover	381	-9	-24	-50
		Sovereign risk	CDS Germany	45	0	-8	16
			CDS Portugal	561	62	85	430
			CDS Spain	218	4	-46	113
			CDS USA	42	0	-5	---
			CDS Emerging	211	-5	-20	-23
			CDS Argentina	602	-40	-69	-302
			CDS Brazil	115	-2	-7	-17
			CDS Colombia	115	-3	-8	-38
			CDS Chile	66	-5	-17	-13
			CDS Mexico	109	-2	-10	-8
			CDS Peru	126	7	9	-4

Source: Bloomberg and Datastream

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