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Weekly Watch
Global

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Economic Analysis

Financial Scenarios
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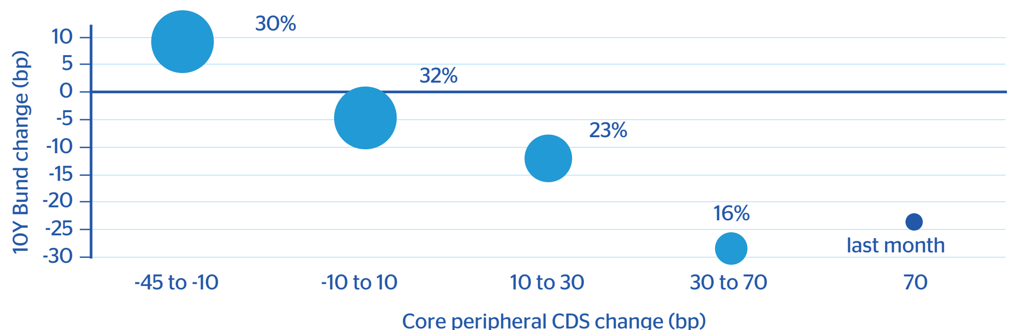
Is additional ECB support more likely?

- **Markets' pressures are mounting on Euro zone sovereign bonds**
  The lack of demand on the German 10Y bond auction has increased concerns about the potential loss of its category as safe asset class. The European Commission has released the consultation Paper on Stability Bonds (Eurobonds). Nevertheless German government has ruled out the Eurobond proposal. Before introducing Eurobonds, they prefer meaningful changes in the EU Treaty (expected proposals in the next European council by December 9, which pursuing fiscal union through greater economic integration and even loss of fiscal sovereignty of Member States to secure fiscal discipline. In our view a greater economic and fiscal integration is needed alongside the introduction of the Eurobonds, in order to provide full acceptance of Eurobonds as a safe asset class. Nevertheless changes in the Treaty would take time since, in principle, the approval by the 27 Member States is needed. In the meantime, short-term actions are required to prevent additional market deterioration. In this regard, both the road moap towards a fiscal union and the new precautionary and liquidity credit lines from both IMF and EFSF, which have attached conditionality, would be good tools to encourage ECB support to Eurozone. Next week the Eurogroup and ECOFIN meetings would bring news about the developments on leveraging EFSF and precautionary credit lines.

- **Growth concerns return after the US Super Committee failed to agree on savings**
  In contrast to the eurozone and in spite of downside risks, economic data in the US over the last month has been stronger than expected –retail sales and industrial production in October have pointed to relatively strong GDP growth in Q4. However, the re-escalation of the crisis in the euro area, which has begun to spread to core countries, and the lack of agreement on savings of the US Super Committee, has increased growth concerns once again. These two worrying signs have tilted the balance of risks on growth further to the downside. On the one hand, financial contagion risks keep increasing; on the other, a fiscal contractionary shock might hit the US economy early in 2012 as the current stimulus –the 2% payroll tax cuts ($110bn per year) and the emergency unemployment benefits ($50bn)– might not be extended beyond December 2011. To further increase global growth concerns, the eurozone might be falling into a recession in Q4: soft data –industrial production was already contracting at a faster pace at the end of Q3– is signalling a contraction in activity as the lack of confidence undermines both spending and investment. Additionally, China's flash (private sector) PMI provided further evidence that growth and exports might weaken, moving into contraction zone at 48.0. However, there are some positive signs. We expect next week's official PMI to stay in the expansion zone.

Chart 1
Monthly average change in 10Y Bund yields (bp) for different movements in the 5Y core peripheral CDS



Source: Datastream and BBVA Research

Economic Analysis

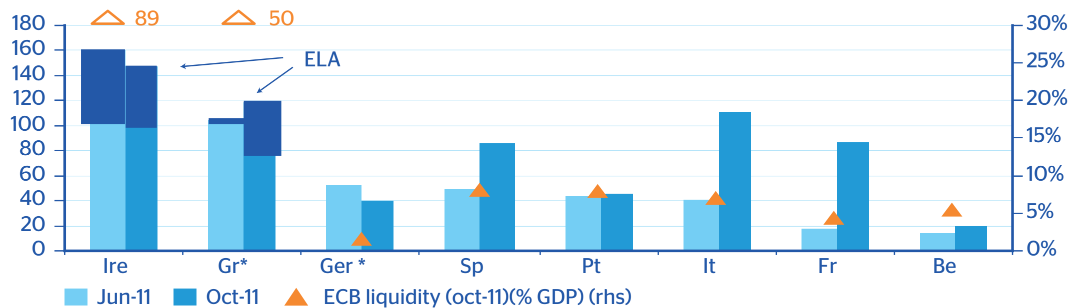
Focus on ECB liquidity

The provision of ECB liquidity has remained in high levels in the last four months. Concretely the latest data released on ECB borrowing referring to October showed a continue increasing their borrowing, including non peripheral countries, which has experienced a sizeable deterioration. Specifically, Italian banks' borrowing from the ECB rose to EUR111.3bn in October from EUR104.7bn in September, far from June´s level (EUR41bn). French banks have also increase significantly the reliance on ECB liquidity since June, about EUR80 bn.

It is remarcable that Greek banks' borrowing from the ECB fell to EUR77.7bn in September (October data have not been published yet), down by 17% since August. But this borrowing has been replaced by ELA, which increased by about EUR20 bn from August to September, showing that Greek banks are running short of collateral that is acceptable to the ECB. Particularly, during this month the three of Greece's biggest banks have issued around EUR 10bn of government-guaranteed bonds, which they probably used as part of the as part of a new EUR30bn liquidity facility created for Greek banks earlier this year. These bonds could be used as collateral to secure financing, either through temporary liquidity facility (ELA) or through ECB, but, this time, probably through ELA because according to the IMF "Contrary to programme expectations, the ECB governing council has not taken a decision on whether to accept as eligible collateral the proposed new €30bn tranche of government-guaranteed bank bonds."

In this context, this week there was speculation that the ECB could announce the extension the term of loans it offers banks to 2 or even 3 years trying to ease the funding problems that European banks face. We consider that more should be done to confront the distortions of liquidity flows across banks, i.e. making collaterals more flexible and establishing guarantees for bank issuance.

Chart 2
ECB: use of MROs & LTROs (bn EUR)



Source: National Central Banks and BBVA Research

Eurobonds: the way toward a fiscal union. The open question is how to encourage high-rated countries to participate in the most ambitious option?.

The European Commission has published a draft on Stability Bonds (Eurobonds). It has been rejected in principle by Germany, but nevertheless contains important insights on how a eventual implementation of Eurobonds may look like.. The rationale behind the SB is to issue bonds that are collectively backed by all countries, thus allowing high-yield member states (MS) to benefit from the stronger creditworthiness of the low-yield MS. This strategy would be complemented by enhanced fiscal discipline in the Euro area to reinforce the stability of fiscal balances in the area and especially to avoid moral hazard (countries not adjusting their deficits but still profiting from the stability of the SB.. Apart from reinforcing creditworthiness and eliminating doubts on countries, other potential advantages of SB are: 1) Reducing market volatility, 2) creating a large and homogeneous European debt market that could serve as alternative to the US Treasury asset class, 3) helping to ensure the monetary policy transmission channel by creating a larger pool of safe and liquidity assets, 4) providing better collateral for banks and 5) reducing home bias risk in banking sector. Thus, to encourage high credit quality MS to participate in SB issuances a mechanism to redistribute some of the funding advantages between the higher- and lower-rated MS may be needed.

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There are different proposals of SB in the EC document depending on the degree of credit risk-sharing between countries. The first option is the "Full substitution of Stability Bonds issuances for national issuances, with joint a several guarantees", where SB cover all the debt of all countries and all MS will be liable not only for its own share of SB issuances but also for the share of any other MS failing to honour its obligation.. This option has the greater pooling of credit risk among countries, but also has the greatest moral hazard risk. The second option is "The partial substitution of national issuance with SB issuances with joint and several guarantees". This alternative is also known as "Blue-Red bonds". SB issuances (blue bonds) would cover certain predefined level of the financial needs and the remaining financial need would be financed by national bonds (red bonds). Member states would be liable for the share of any MS in the SB issuances (blue bond), while national issuances will be backed by national government. In this option it would be very important to decide the relative proportions of SB and national bond (some studies suggests 60% of GDP in blue bonds), knowing that lower SB issuances would entail a lower moral hazard risk, but also a lower advantage in terms of credit risk reduction. The third option is the "partial substitution of national issuances with SB issuances but not joint guarantees". In this option, liabilities are not commonly shared by MS, so there is no credit risk transfer from high-rated countries to lower-rated countries, although lower rated countries would benefit from the higher liquidity of the SB but at the same time the reinforcement of their fiscal discipline is required in order to achieved the advantage of the SB.

The first two options require major changes of the EU Treaty. Therefore, they can not be implemented in the short term, although its announcement would likely have an important impact on markets. The third option does not need major changes in the treaty. Nevertheless is hard to see improvement in current market conditions under this proposal, unless a large credit enhancement is included. In our view, to address the current market disruptions, a decisive step should be taken, which implies major Treaty changes. In the meantime ECB support is required.

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Interest Rates: So...is Germany in the Eurozone?

As we began to warn following last week's 2Y auction in Germany, this country's curve is losing some of its importance as a safe-haven asset. Further proof came on Wednesday with the 10Y auction, at which Germany failed to place all of its debt and the Bundesbank ended up with 39% of the targeted EUR6bn, vs. 20% at previous auctions. German paper's fading allure is also illustrated by its relative performance against the Eonia curve, with widening seen in recent days, quite unlike the performance seen during other outbreaks of major turmoil. Although it might seem that this lower demand at the auctions is due to unattractive rates, this is not the case, since the 2Y and 7Y US auctions in the same week (with extremely low rates) saw the highest bid-to-cover ever. In fact, the 10Y spread between the Treasuries curve, which continues to price in flight to quality flows, and the German curve has widened by 50bp over the last week. Even so, it is important to note that the short end of the curve, specifically German T-bills, remains one of the preferred investments at present, and this, together with the end of year calendar effect, means that they are trading with negative interest rates..

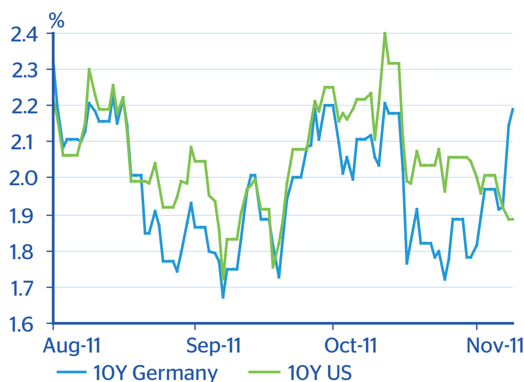
Forex: FX market awaiting further details of EFSF

Risk-sensitive currencies are continuing to suffer from pressure caused by concerns over macro data and the global financial situation. On Monday, the US Super Committee failed to reach an agreement on spending cuts. Although risk appetite was affected by the news, we do not appear to be facing a budgetary disaster, since there is already a plan B to apply automatic spending cuts of up to USD1.2bn from the start of 2013. In addition, the poor results of European auctions, together with some downbeat macro data did not help to dispel investors' concerns. Although some data, such as the German IFO survey and US durable goods orders beat expectations, the declines shown by China and the EMU's manufacturing surveys increased uncertainty over the performance of the global economy, reducing risk appetite. Nonetheless, two important factors helped to limit falls in risk-sensitive currencies. Firstly, the IMF announced preventative changes to its credit line for solvent countries that are facing liquidity problems. Secondly, the FOMC minutes suggested that some committee members considered that more stimulus measures are needed, in the form of purchases of MBS in 1Q12.

Credit: Germany not immune to contagion

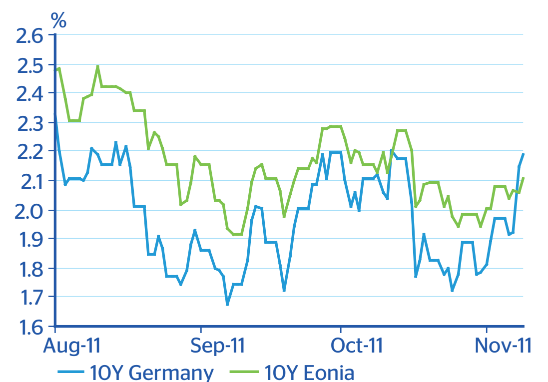
On credit markets, the fragility of the Eurozone is starting to have an increasingly clear effect on core Member States, as a result of increased nervousness among investors in response to the lack of a solution to the sovereign debt issue. On Wednesday, the German 5Y CDS widened 7bp to 108bp due to the poor performance at its 10Y auction, placing just EUR3.6bn of the EUR6bn target. To get an idea of the penalization of the 5Y German CDS in recent days, it is interesting to compare it to the UK CDS. While over the last year the German CDS has traded 10bp together than its UK counterpart, it is currently trading 10bp wider (108bp vs. 98bp). The disappointing German auction lifted yields on Spanish and French government bonds as well on Wednesday. As confidence wavered, the European Central Bank again moved to support the euro-zone government debt market with purchases of Italian and Spanish bonds. Synthetic indexes have widened so far this week, most reaching highs on Wednesday: iTraxx Main 209bp, iTraxx Fin Senior 342bp and SovX 381bp. On the primary market, activity is still limited, and in financials the covered bond purchase programme has not yet had the desired effect.

Chart 4
10Y Germany and 10Y US



Source: Bloomberg and BBVA Research

Chart 5
10Y Germany and 10Y Eonia Swap



Source: Bloomberg and BBVA Research

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Calendar: Indicators

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

Forecast: 3.0% y/y	Consensus: 3.0% y/y	Previous: 3.0% y/y

Comment: Both headline and core inflation should have remained unchanged in November for the third month in a row, after the acceleration observed in September due to methodological changes, and suggesting that inflation has already peaked. Uncertainty about inflation forecasts has increased in recent months, due to these methodological changes along with the Italian VAT hike in mid-September. We continue to see a slowdown in inflation in December, to fall below the ECB target late in the first quarter of 2012. Regarding core inflation, we expect it to hover around current rates for the remainder of the year, moderating somewhat afterwards. **Market Impact:** We think that flash inflation will not have a significant impact on markets, as risks are balanced while major concerns are focused on the impact of the unresolved sovereign debt crisis on growth. .

Eurozone: Unemployment rate (October, November 30th)

Forecast: 10.3%	Consensus: 10.2%	Previous: 10.2%

Comment: We expect unemployment rate to have stepped up in October, after raising also in September. In addition, last month revised figures for the year showed that the unemployment rate increased by around 0.3pp since April, in contrast with the stabilization suggested by previous figures. Recent economic data suggesting a mild contraction in Q4 along with higher uncertainty in coming quarters are weighing on firms' hiring intentions, which are worsening further according to the EC survey. All these figures show further evidence of a deterioration in the labour market in the short-term. **Market impact:** A worse than expected outcome would increase the concerns about a deeper recession. .

US: ISM Manufacturing Index (November, December 1st)

Forecast: 51.0	Consensus: 51.7	Previous: 50.8

Comment: The ISM manufacturing index has hovered near the no-growth boundary throughout the past four months, and we do not expect much change in November. New orders and production have picked up in recent months, and declining price pressures suggest easing conditions for manufacturers. Regional Federal Reserve surveys indicate some growth in the manufacturing sector, but demand expectations remain mixed. Thus, we expect the ISM index to remain near the 50-mark to indicate only minimal expansion in the sector. **Market Impact:** A breakthrough in manufacturing indicators could reduce fears of further downward revisions to GDP growth and ease worries of vulnerability to conditions overseas.

US: Nonfarm Payroll and Unemployment Rate (November, December 2nd)

Forecast: 110K, 9.0%	Consensus: 112K, 9.0%	Previous: 80K, 9.0%

Comment: The employment situation has improved gradually in recent months, but payrolls remain at only a fraction of pre-recession levels. Initial jobless claims have declined throughout November, dropping below the 400 level for the first three weeks. Improvements in the housing market suggest some growth in construction employment, however, hiring in the manufacturing sector remains mixed. Furthermore, weakness in government employment continues to drag on total payrolls. While job availability appears to be improving, it has not been enough to significantly decrease the unemployment rate. **Market Impact:** While much of the focus remains on Europe, markets will pay close attention to employment indicators in the US. Significant job growth could soften the blow from the Supercommittee's failure, which has increased market uncertainties regarding fiscal stability.

China: PMI (November, December 1st)

Forecast: 50.1	Consensus: 49.8	Previous: 50.4

Comment: GDP growth as so far been moderating in line with a soft landing. However, downside risks have increased due to external headwinds and the effects of recent policy tightening. The latest flash estimate of the private sector (Markit) PMI for November fell sharply, to 48.0 in November from 51.0 in October. However, as the official PMI covers a larger set of domestically-oriented companies which are still growing, we expect the index to remain just within the 50+ expansion zone for November. **Market impact:** A lower-than-expected reading would aggravate concerns of a hard-landing, raising expectations of further policy stimulus in China, and denting already weak sentiment about global growth prospects.

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			Close	Weekly change	Monthly change	Annual change
Interest Rates (changes in bps)	US	3-month Libor rate	0.52	3	9	22
		2-yr yield	0.27	0	-1	-23
		10-yr yield	1.95	-6	-25	-91
	EMU	3-month Euribor rate	1.48	1	-11	45
		2-yr yield	0.46	-1	-6	-47
		10-yr yield	2.26	29	22	-47
Exchange Rates (changes in %)	Europe	Dollar-Euro	1.328	-1.7	-4.0	0.3
		Pound-Euro	0.86	0.1	-1.4	1.0
		Swiss Franc-Euro	1.23	-0.3	0.8	-7.0
	America	Argentina (peso-dollar)	4.26	0.2	0.7	7.2
		Brazil (real-dollar)	1.88	5.4	6.5	8.9
		Colombia (peso-dollar)	1945	1.6	3.3	1.9
		Chile (peso-dollar)	526	2.8	4.9	8.8
		Mexico (peso-dollar)	14.22	3.3	5.2	13.8
		Peru (Nuevo sol-dollar)	2.71	0.3	-0.3	-3.8
	Asia	Japan (Yen-Dollar)	77.64	0.9	2.1	-7.6
		Korea (KRW-Dollar)	1164.29	2.2	2.7	0.0
		Australia (AUD-Dollar)	0.975	-2.7	-5.7	1.1
Comm. (chg %)		Brent oil ($/b)	107.5	0.0	-1.3	25.7
		Gold ($/ounce)	1693.9	-1.7	-1.8	24.2
		Base metals	523.3	-0.8	-2.5	-4.6
Stock Markets (changes in %)	Euro	Ibex 35	7728	-7.0	-12.5	-19.1
		EuroStoxx 50	2109	-5.7	-9.7	-23.0
	America	USA (S&P 500)	1171	-3.7	-5.7	-1.5
		Argentina (Merval)	2435	-3.7	-15.5	-26.3
		Brazil (Bovespa)	55477	-2.2	-2.9	-18.7
		Colombia (IGBC)	12171	-3.9	-9.1	-18.4
		Chile (IGPA)	19441	-5.1	-2.9	-15.5
		Mexico (CPI)	35607	-1.9	-0.6	-3.5
		Peru (General Lima)	18993	-1.3	-1.8	-8.3
		Venezuela (IBC)	115432	0.0	8.3	74.6
	Asia	Nikkei225	8160	-2.6	-6.7	-18.7
		HSI	17689	-4.3	-7.2	-22.7
Credit (changes in bps)	Ind.	Itraxx Main	207	19	33	97
		Itraxx Xover	841	81	122	348
	Sovereign risk	CDS Germany	111	16	25	66
		CDS Portugal	1105	52	-5	599
		CDS Spain	480	24	101	157
		CDS USA	56	5	15	---
		CDS Emerging	347	22	50	123
		CDS Argentina	1081	88	106	417
		CDS Brazil	190	13	35	75
		CDS Colombia	188	13	34	72
		CDS Chile	150	9	31	64
		CDS Mexico	188	13	36	71
		CDS Peru	190	12	33	66

Source: Bloomberg and Datastream

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