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Weekly Watch
Global

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Economic Analysis

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Focus shifts to September FOMC meeting

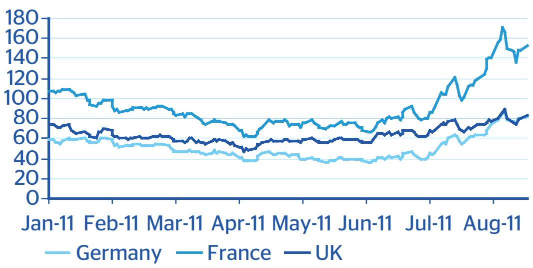
Markets have been in a good mood on hopes that Bernanke will pre-announce additional stimulus at Jackson Hole.. Bernanke's speech contained little guidance but he repeated that the Fed "has a range of tools that could be used to provide additional monetary stimulus", said that pros and cons were discussed at FOMC's August meeting, and more importantly, said that the September FOMC meeting was expanded to two days (the 20th and the 21st) instead of one "to allow a fuller discussion". Bernanke shifted the focus to September and although there were no hints of additional Fed action, he left the door open by reiterating that the Fed "is prepared to employ its tools as appropriate". Meanwhile, CDS's of European banks' have risen well beyond previous highs and are still widening. This troubling trend is not only a reflection of EZ problems (investors have moved away from risky assets), but worries about contagion from sovereign to banks are certainly the main driver. Focus next week will be on the US Employment Report.

Highlights

USD funding in the spotlight

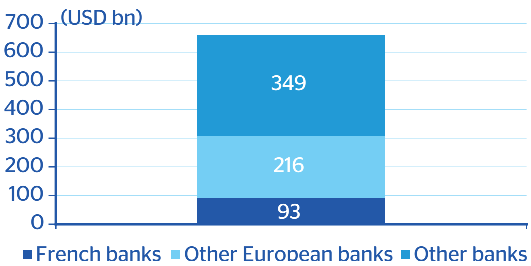
In recent days, market concerns on a worsening of European banks' USD funding capacity have increased as result of a combination of factors: 1) European banks have been squeezed for dollar funding, 2) the 3m EUR/USD cross currency basis swap reached minus 96bp last week and 3) the borrowing of USD500mn by one European bank at the ECB's regular 1w USD liquidity operation last Wednesday. But the situation is still not as worrying as that of the Lehman collapse for several reasons: 1) banks have resorted to the FX market to swap euros into dollars; 2) last week's ECB transaction was a one-off and it has not been renewed, in fact, the amount borrowed was low compared with the period of stress in May last year or 2008; 3) the repo market is an alternative to commercial paper, but it is less risky as the loans are backed by high grade assets; and 4) foreign banks have built up a buffer of dollar reserves at the Fed and have disposable assets to be used at the discount window.

Chart 1
5Y CDS spread (basis points)



Source: Datastream and BBVA Research

Chart 2
Exposure of 10 largest US money markets funds



Source: Fitch Ratings

Markets

Equity markets are oversold and pricing in an overly negative outlook

Equity markets are rallying this week for various reasons: i) the equity risk premium is too high and has reached the same level as in 2009 and at the time of the Lehman Brothers bankruptcy; ii) equity markets are discounting a drop in earnings in 2012 of -14% in the case of the S&P 500 and -38% for the EuroStoxx 50; iii) consensus earnings estimates are stable for the S&P 500, but there have been continued cuts to forecasts for the EuroStoxx 50 (-4.7% 11e and -5.7% 12e YTD); iv) at least on the face of it, valuations are currently very attractive: P/E 11e S&P 500 11.3x and EuroStoxx 50 7.8x; v) there has been some relief from economic data (PMIs in China and Europe and factory orders in the US); vi) covered bonds have been issued (ING, UBS and Unicredit), providing some hope that the credit market will reopen, which is perhaps the most important factor at present; vii) the IRR of 10Y US and German bonds has risen, and; 8) the performance of some cyclical commodities such as copper is more than acceptable, which does not point to a sharp drop in global growth. In any case, the macro outlook is of a global slowdown. Right now the situation in Europe is one of systemic risk, and any recovery on equity markets will not hold up unless the CDS's of European banks ease from their current highs, and bank funding normalises in Europe.

Economic Analysis

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Calendar: Indicators

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

Forecast: 2.6% y/y	Consensus: 2.5% y/y	Previous: 2.5% y/y

Comment: we expect HICP inflation to increase slightly in August, as we consider the decline in July to be temporary and explained by methodological changes along with the larger than expected impact of the sales season this year, which has significantly affected prices of non-energy industrial goods. We therefore expect these prices to increase in August, and this combined with slightly higher inflation in both services and processed food should result in a slight increase in core inflation. In contrast, inflation in more volatile components is expected to remain broadly stable. It is to be noted that the mentioned methodological changes have increased uncertainty around forecasts for the full year. **Market Impact:** a further acceleration of inflation should not greatly affect markets, as fears about the fragility of the recovery are the focus of attention, and this, combined with unresolved sovereign debt crisis, should not change how the market expects the ECB to act in the coming months.

Eurozone: Unemployment rate (July, August 31st)

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

Comment: we expect the unemployment rate to remain unchanged in July, as observed since the beginning of the year. However, sentiment surveys for both July and August have shown that hiring intentions have worsened somewhat in recent months, driven by disappointing growth figures in Q2 and increasing uncertainty about the economic outlook in the second half of the year. **Market impact:** Given the lag between growth and employment, we do not see major changes in unemployment, although worse than expected outcomes could increase the concerns of a return to recession.

US: Personal Income and Outlays (July, 29th)

Forecast: 0.2%, 0.3%	Consensus: 0.3%, 0.4%	Previous: 0.1%, -0.2%

Comment: personal income is expected to grow in July despite continued weakness in the labor market and uncertainties regarding future employment. Also, growth of personal expenditures is expected to rebound after declining MoM in June for the first time in 12 months. Decreasing consumer confidence throughout the summer months may have had an impact on real spending habits, but rising prices are likely to have inflated the volume of personal expenditures. In general, we expect the slower-than-expected recovery to keep figures low in real terms. **Market Impact:** any indications of weaker-than-expected consumer demand and activity will likely cause some anxiety in the markets.

US: Non-farm Payroll and Unemployment Rate (August, 2nd)

Forecast: 100k, 9.1%	Consensus: 95k, 9.1%	Previous: 117k, 9.1%

Comment: the conservative employment outlook extends into August, with nonfarm payrolls expected to add fewer jobs than in July. The private sector has led employment growth in recent months, however job creation is likely to decelerate as fears of future layoffs spread through the market. Continued cuts in government spending are likely to negatively impact non-farm payrolls for the tenth consecutive month. Despite declines in initial jobless claims throughout July, claims in August have reverted back to upward trends. With no indications of improvement in the labor market, we do not expect the unemployment rate to decline. **Market Impact:** continued weakness in the employment situation will increasingly capture market attention, particularly if surprises to the downside signal the possibility of a double-dip recession.

China: PMI for August (September 1st)

Forecast: 51.4	Consensus: 51.0	Previous: 50.7

Comment: China's Purchasing Managers' Index (PMI) for August will be next week's focus of attention for gauging China's underlying growth momentum amidst global financial turbulence and signs of weakening external demand. After four-months of consecutive declines, we expect the PMI to rebound, reflecting seasonal trends and a pickup in the HSBC flash PMI estimate (released last week). This would be consistent with our soft-landing scenario and 9.4% GDP projection for 2011. **Market impact:** a significantly weaker-than-expected reading could aggravate market concerns of a sharper slowdown, with negative implications for global growth, and increase expectations of looser macro policies in China and elsewhere.

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Markets Data

			Close	Weekly change	Monthly change	Annual change
Interest Rates (changes in bps)	US	3-month Libor rate	0.32	2	7	3
		2-yr yield	0.19	0	-25	-36
		10-yr yield	2.21	14	-77	-44
	EMU	3-month Euribor rate	1.54	1	-7	65
		2-yr yield	0.63	-2	-64	-1
		10-yr yield	2.14	3	-51	-6
Exchange Rates (changes in %)	Europe	Dollar-Euro	1.436	-0.3	0.0	12.6
		Pound-Euro	0.89	1.7	0.6	7.7
		Swiss Franc-Euro	1.17	2.9	1.1	-11.0
	America	Argentina (peso-dollar)	4.19	0.2	1.2	6.0
		Brazil (real-dollar)	1.61	0.6	2.8	-8.2
		Colombia (peso-dollar)	1794	0.7	1.5	-1.2
		Chile (peso-dollar)	467	-0.2	2.2	-6.7
		Mexico (peso-dollar)	12.53	2.3	7.5	-3.9
		Peru (Nuevo sol-dollar)	2.73	-0.4	-0.2	-2.4
	Asia	Japan (Yen-Dollar)	77.03	0.8	-1.4	-9.7
		Korea (KRW-Dollar)	1081.95	-0.5	3.0	-9.2
		Australia (AUD-Dollar)	1.051	0.7	-4.6	17.2
Comm. (chg %)		Brent oil ($/b)	110.1	1.3	-6.3	43.6
		Gold ($/ounce)	1776.6	-4.1	10.1	43.5
		Base metals	565.5	-0.1	-5.2	12.4
Stock Markets (changes in %)	Euro	Ibex 35	8113	-0.4	-15.9	-20.1
		EuroStoxx 50	2172	0.6	-19.4	-17.4
	America	USA (S&P 500)	1163	3.5	-10.9	9.3
		Argentina (Merval)	2848	0.8	-12.9	21.2
		Brazil (Bovespa)	53206	1.4	-8.7	-18.9
		Colombia (IGBC)	13160	1.6	-5.6	-5.3
		Chile (IGPA)	19661	-0.8	-7.0	-6.5
		Mexico (CPI)	33816	2.0	-5.0	6.5
		Peru (General Lima)	19463	0.4	-11.4	28.8
		Venezuela (IBC)	99620	0.7	12.0	53.8
	Asia	Nikkei225	8798	0.9	-12.4	-2.1
		HSI	19583	0.9	-13.1	-4.9
Credit (changes in bps)	Ind.	Itraxx Main	168	14	53	50
		Itraxx Xover	701	41	266	174
	Sovereign risk	CDS Germany	85	4	23	41
		CDS Portugal	1039	138	81	706
		CDS Spain	376	11	61	129
		CDS USA	47	0	-15	---
		CDS Emerging	300	24	85	41
		CDS Argentina	842	65	240	-99
		CDS Brazil	163	16	48	34
		CDS Colombia	161	18	49	29
		CDS Chile	105	6	35	29
		CDS Mexico	162	16	50	29
		CDS Peru	171	18	46	57

Source: Bloomberg and Datastream

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