BBVA Research

Global

Weekly Watch

Madrid, 28 January 2011

Economic Analysis

Financial Scenarios
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Debt remains the central focus

The outcome of the greater consensus at a European level is a positive trade-off between core European countries ensuring the euro's stability and fiscal consolidation in peripheral countries in return for this. European, German and French authorities are closer to reinforcing the EFSF, but with a high conditionality. In this context, next week the Zapatero-Merkel meeting and the European Council meeting will take place at the right moment. Spain has done part of its homework: the Cabinet has passed the pension reform and a new plan has been announced that will accelerate the restructuring process of the financial system and furthermore the 2010 central government deficit was below target.

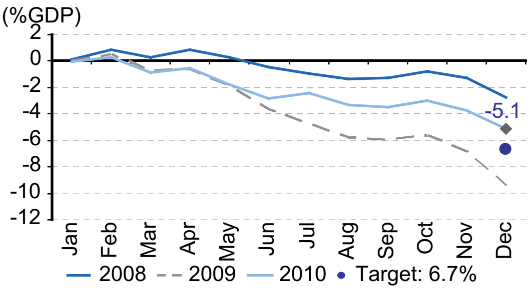
However, concerns regarding high public deficit are spreading to areas other than the EU. The IMF in its WEO report signals that: "… the absence of a credible, medium-term fiscal strategy would eventually drive up the US interest rate". In addition, S&P has downgraded Japan because of its high level of debt. Also Moody's gave the US a warning because of the indebtness. In the US we have seen slightly positives steps. The president emphasized his objective to cut the deficit in the State of the Union address.

Fed's focus on downside risks to growth vs. others' alertness on inflation

The last FOMC statement indicated no major changes to the current monetary policy stance. FOMC members indicated some improvement in consumer spending but also noted that core inflation is continuing to trend downward. In contrast, we saw some movement in the BoE toward a more hawkish tone, as a new member had joined Andrew Stance in voting for a rate hike. Regarding the ECB we do not expect major wording changes or surprises from the ECB monetary policy statement. The previous statement already marked a shift in focus from non-standard measures to inflation risks. Their main concern is inflation and they will thus maintain the hawkish tone. Nonetheless, we do not anticipate more hawkishness. At least for now, communication is their key monetary policy instrument to anchor inflation expectations. In short, the tone is all about prevention. Next week: several indicators will be released in the US, including Payrolls and ISM. In the Eurozone January CPI will be released.

Chart 1

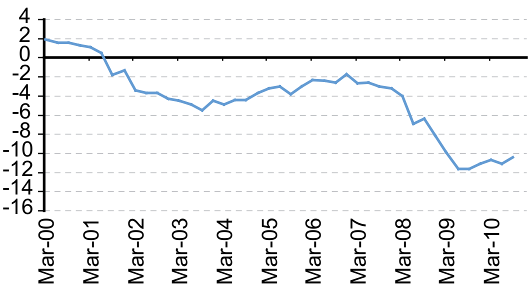
Spain Central Government Budget Deficit



Source: BBVA Research based on Spanish Ministry of the Economy

Chart 2

US Fiscal Deficit over GDP (%)



Source: Datastream and BBVA Research

Highlights

Domestic demand outlook in developed countries

Most of the improvement lies in foreign demand orders or benign fiscal policies, meaning that a self-sustained, private-led recovery is still in the making.

2011: mostly positive for sovereign risk in Emerging Markets

Further tightening in CDS in emerging markets is likely but market participants should start discriminating.

Obama pledges to rein in deficit and boost business

Obama's State of the Union address reduced the tail risk on taxes and regulation and boosted business confidence which is likely to feed into a stronger recovery.

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Markets

FED and ECB: each to their own

On one hand, the Fed took the opportunity at the FOMC to reinforce the message that it is prepared to maintain the current monetary stimuli. On the other hand, the ECB took the opposite stance, insisting that it is prepared to act should expected inflation start to react to recent price trends. The effect of this message has also been reinforced by this week's price data which continue to reflect the effects of commodities (import prices above 12% YoY in Germany). These differing attitudes are also reflected in contrasting performance between curves: there has been some dovish flattening in the USD Libor futures curve (end-2011 and 2012 contracts), which contrasts with the continued hawkish steepening in the Euribor curve (Jun 2012 already above 2.20%). The continuation of this relative performance is particularly dependent on the rhetoric of each central bank. The ECB is very likely to maintain the same attitude at the meeting secheduled for 3 February, which in the short term may feed the market's more hawkish concerns. However, the message being sent out, and therefore the market's reaction, may fade over time: one must remember that the ECB insists that its aim is for "expected prices to remain anchored". Therefore, as this "imported inflation" factor starts to revert, or at least ends up confirming in time that it will not necessarily transfer to other CPI components, concerns over a "hawkish" market may recede.

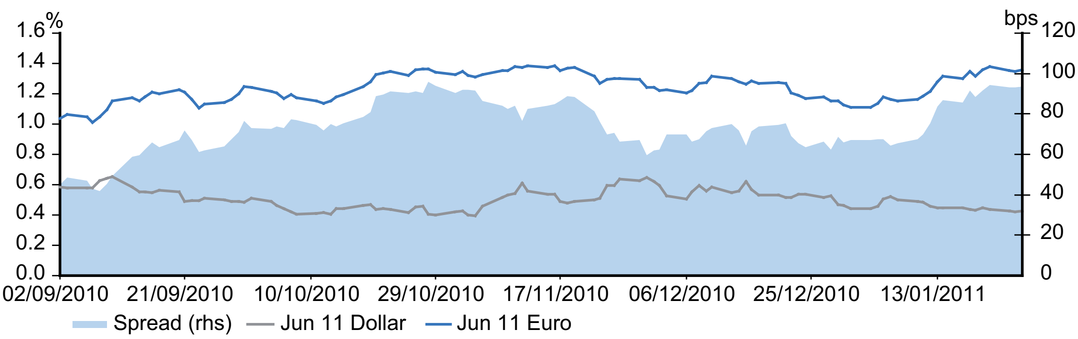
Stock exchanges are reaching key levels

The tone of equity markets remains bearish, and the main equity indices are approaching "ceilings". The S&P 500 and EuroStoxx 50 are at key levels, in terms of technical resistances and psychological levels, 1,300 and 3,000 points. The Ibex is also closing in on a key level, 11,000 points.

Better than expected US corporate earnings and a global macro context which supports equity continue to be the main drivers of markets. However, perhaps the most significant factor is the fact that for the 165 companies that have posted earnings from the S&P 500, sales have grown 7.3% YoY. We are therefore seeing an improvement in earnings which is not only a result of cost cuts, but also improved sales, an essential factor during this phase of the economic and equity cycles.

In this context, we believe that the major indices will find it difficult to break above the resistances at the first attempt, following the rally they have accumulated, and in the coming days we could see some profit-taking, but there should not be any larger falls. We are still more confident of European than US indexes given the spread between their performance since September 2010 is still considerable and that European banks have more upside potential than their US counterparts (helped by the reforms to the savings bank system in Spain). Lastly, we believe that the euro is overbought vs. the dollar. This could be an additional help in case of a return to the 1.30/1.25 zone.

Chart 3
3M Euro and Dollar Rates Discounted for Jun 2011 vs. Spread



Source: Bloomberg

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Highlights

Domestic demand outlook in developed countries

Central Banks' statements have been echoing the positive trend in domestic economic indicators. Up to now, most of the improvement lies in foreign demand orders or benign fiscal policies, meaning that a self-sustained, private-led recovery is still in the making. In the case of the Eurozone, the pace of recovery in private consumption is still moderate, although there is a wide divergence between peripheral and core countries. In Germany in particular, and also in France, consumption showed stronger growth, and the improvement in the German labour market provides further support for a sustainable rebound in consumption in this country. Regarding investment, in the Eurozone utilization capacity has hit 80% and inventories are at historical long-term levels, paving the way for further investment growth. In the US the economic recovery is mainly supported by solid foreign demand and ongoing growth in personal consumption expenditure. Robust growth in personal spending and imports also points to an internal demand recovery in the U.S. Also, consumers face a less uncertain tax environment which has boosted consumer expectations. In addition, recent improvements in labor market conditions and strong retail sales suggest a robust increase in personal spending and imports in 2011. Nonetheless, the recovery remains highly dependent on both fiscal and monetary stimuli. High unemployment, tight credit conditions and reduced housing wealth will continue to limit the pace of consumption growth and imports. The inventory re-stocking should boost investment and lead to higher GDP growth.

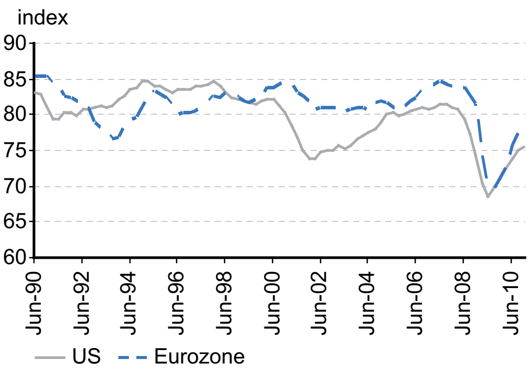
2011: mostly positive for sovereign risk in Emerging Markets

Our forecasts for the world economy in 2011 tend to favour the view that we should see a further tightening of credit risk premiums in emerging markets. Regarding systematic risk, while direct contagion from the European crisis has been limited, we suspect the unfolding of events has prevented a further reduction in risk aversion that would have probably followed after the Fed's QE2. Accordingly, any form of resolution of European woes (barring a doomsday scenario, which we still see as unlikely) could result in further downward pressure on EM credit default swaps. Our sovereign country risk model suggests stable but still positive macro conditions should accommodate this reduction, even if some countries are forced to sacrifice some growth with additional tightening measures. On a more negative note, countries that fail to rein in inflation could be particularly penalized in 2011, and those with poorer institutional conditions may be subject to setbacks in a scenario of progressive normalization of market pricing.

Obama pledges to rein in deficit and boost business

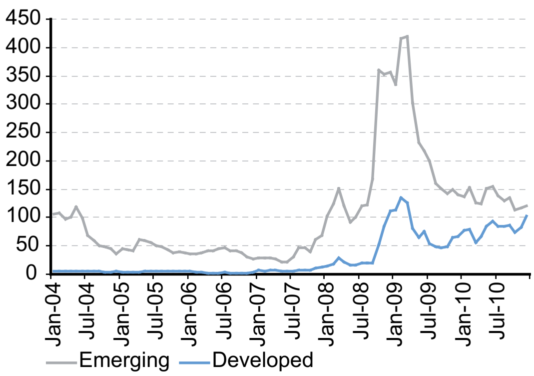
The US State of the Union provided clarity to the business community. Obama vowed to reduce corporate taxes without increasing the deficit, and burdensome regulation. The President emphasized his desire to cut the deficit, working with the opposition. It is extremely encouraging that both sides are agreeing to cuts, even though it is not key known where they will be made. Obama wants to redouble the effort in infrastructures by investing in energy, high speed rail, and attracting private investment, among other measures. The President's targets for structural reforms are ambitious and if achieved would substantially improve the competitiveness of the United States. Overall, Obama's speech reduced the tail risk of potential negative news on taxes and regulation and boosted business confidence, which is likely to feed into a stronger recovery.

Chart 4
Capacity Utilization



Source: BBVA Research

Chart 5
The Convergence of Emerging and Developed Sovereign Risk Premiums Continues*



* Median of 5 year Sovereign Credit Default Swaps (USD) Emerging markets
Source: CMA

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Calendar: Indicators

Eurozone: Flash inflation estimate (January, January 31st)

Forecast: 2.3% y/y	**Consensus:** 2.4% y/y	**Previous:** 2.2% y/y

Comment: Headline inflation is expected to accelerate again to 2.3% y/y in January. In contrast with the previous months, the main driver could be the increase of around 0.1pp in core inflation, due to higher prices of both processed food and non-energy industrial goods. Regarding energy inflation, the recent increase in oil prices along with energy tax hikes may have offset the moderation in annual energy inflation due to the base effect. It is also worth mentioning that the new weights for 2011 introduced this month add uncertainty to the January forecast. **Market impact:** We see some upside risks to our projection, especially in the energy component, as fuel prices have been rising in the early weeks of January and the final impact of energy tax hikes is uncertain (as in Spain). The latter could be offset by a larger than estimated sales effect as a consequence of the weakness of domestic demand. A positive surprise could significantly affect markets, as they may fear more hawkish rhetoric from the ECB later in the week.

Eurozone: Unemployment rate (December, February 1st)

Forecast: 10.1%	**Consensus:** 10.1%	**Previous:** 10.1%

Comment: The unemployment rate is expected to have remained stable in December, in line with what has been observed since early this year, supported by the positive economic momentum, which has remained in Q4. Hiring intentions from the EC survey improved again in December, continuing the upward trend observed since end-2009, especially in the industrial sector, although they remain at very low levels. In contrast, consumers' unemployment expectations have stabilized in recent months, interrupting the positive trend observed in previous months. On average, the unemployment rate in 2010 could have increased around 0.5pp over the 2009 average of 9.5%. We expect the unemployment rate to remain more or less stable at its current level in the coming months, in line with a scenario of weaker activity. **Market impact:** No large surprises are expected. A negative surprise would be interpreted as a sign of renewed downward pressures in economic activity.

US: Personal Income and Outlays (December, January 31st)

Forecast: 0.4%, 0.4% m/m	**Consensus:** 0.4%, 0.5% m/m	**Previous:** 0.3%, 0.4% m/m

Comment: Since July 2010, personal spending has increased 0.5% on average on a m/m basis. The latest macroeconomics indicators such as retail sales, consumer confidence and non-farm payrolls suggest that this trend continued in December. With new tax incentives and political dynamics after the November elections, consumers face a less uncertain tax environment which has boosted consumer expectations. We expect recent trends in income growth, retail sales, relative improvement in labor market conditions and consumer optimism to push personal spending up in the coming months. However, high unemployment, reduced household wealth and tight credit conditions will continue to limit the pace of consumption growth. **Market impact:** Better-than-expected personal spending and income numbers will push optimism even higher in the financial markets.

US: Non-farm Payroll, private (January, February 4th)

Forecast: 140K, 150K	**Consensus:** 130K, 150K	**Previous:** 103K, 113K

Comment: In December, total and private non-farm payrolls rose 103K and 113K, respectively. Most of the job creation came from the service-providing industries where the total private service-providing industries created 115K new jobs in December. Job creation in mining and manufacturing was limited. In line with subdued residential investment activity, construction employment declined 16K. On the other hand, the unemployment rate declined 0.4pp to 9.4% due to the decline in participation rate and labor force. We expect nonfarm payroll employment to gain momentum in 2011. However, even with strong employment growth, the unemployment rate is expected to remain elevated in 2011 due to a possible increase in the labor force and participation rate. Market impact: Stronger-than-expected job creation in January would be a significant sign of improvement in labor market conditions and would be welcomed by the financial markets and the Fed.

China: PMI (January, February 1st)

Forecast: 54.0	**Consensus:** 53.5	**Previous:** 53.9

Comment: Recent indicators point to stronger-than-expected growth momentum, underscored by rapid GDP growth in Q4 and new loans continuing to increase beyond the authorities' target range. By all accounts, manufacturing activity is set to expand at a robust pace in January. **Market impact:** Given concerns about overheating, a stronger than expected outturn might raise expectations of front-loaded tightening measures, and could increase the likelihood of another imminent interest rate hike by the PBoC, which could further undermine financial market sentiment.

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Markets Data

				Close	Weekly change	Monthly change	Annual change
Interest Rates	(changes in bps)	US	3-month Libor rate	0.30	0	0	6
			2-yr yield	0.59	-2	-4	-22
			10-yr yield	3.42	2	7	-17
		EMU	3-month Euribor rate	1.06	4	5	40
			2-yr yield	1.43	15	55	32
			10-yr yield	3.20	3	19	1
Exchange Rates	(changes in %)	Europe	Dollar-Euro	1.371	1.0	4.0	-1.3
			Pound-Euro	0.86	1.5	1.2	-0.6
			Swiss Franc-Euro	1.29	-0.5	3.4	-12.1
		America	Argentina (peso-dollar)	4.00	0.4	0.4	4.2
			Brazil (real-dollar)	1.67	0.1	-0.2	-11.2
			Colombia (peso-dollar)	1852	0.6	-4.8	-6.6
			Chile (peso-dollar)	483	-1.7	3.0	-7.9
			Mexico (peso-dollar)	12.03	-0.4	-2.7	-7.6
			Peru (Nuevo sol-dollar)	2.77	0.1	-1.1	-2.9
		Asia	Japan (Yen-Dollar)	82.30	-0.5	0.6	-9.0
			Korea (KRW-Dollar)	1111.90	-0.7	-2.7	-4.1
			Australia (AUD-Dollar)	0.998	0.9	-1.8	12.3
Comm.	(chg %)		Brent oil ($/b)	97.5	-0.1	3.5	36.4
			Gold ($/ounce)	1318.0	-1.8	-6.6	21.9
			Base metals	603.6	1.2	4.1	27.1
Stock Markets	(changes in %)	Euro	Ibex 35	10854	0.2	8.7	-0.9
			EuroStoxx 50	2990	0.7	5.2	7.7
		America	USA (S&P 500)	1302	1.5	3.4	21.3
			Argentina (Merval)	3622	-0.7	2.8	57.6
			Brazil (Bovespa)	67692	-2.1	-1.8	3.5
			Colombia (IGBC)	15104	1.0	-2.8	30.8
			Chile (IGPA)	22440	-2.6	-1.7	27.5
			Mexico (CPI)	37448	0.3	-2.0	23.2
			Peru (General Lima)	22504	3.9	-2.9	55.8
			Venezuela (IBC)	66098	0.2	1.4	11.5
		Asia	Nikkei225	10360	0.8	0.2	1.6
			HSI	23617	-1.1	2.8	17.4
Credit	(changes in bps)	Ind.	Itraxx Main	100	0	-6	17
			Itraxx Xover	412	1	-27	-42
		Sovereign risk	CDS Germany	60	4	2	26
			CDS Portugal	459	21	-40	299
			CDS Spain	276	10	-74	152
			CDS USA	50	2	9	---
			CDS Emerging	209	7	7	-64
			CDS Argentina	558	14	-43	-469
			CDS Brazil	115	6	3	-29
			CDS Colombia	115	5	1	-53
			CDS Chile	82	2	-5	5
			CDS Mexico	117	4	3	-33
			CDS Peru	109	2	-5	-36

Source: Bloomberg and Datastream

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