

# Weekly Watch

## Global

Madrid, 28 October 2011  
**Economic Analysis**

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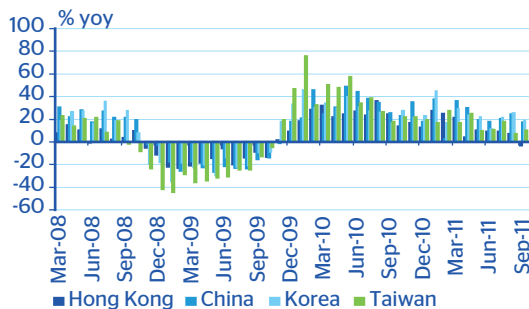
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## Better picture, but risks remain

- EU plan and US growth lift sentiment**  
 Risk premium eased sharply and risk assets rallied on the back of a positive surprise from the EU summit (after expectations have turned rather pessimistic earlier this week). The European Council delivered measures, which will help to underpin sovereign funding markets, achieve a sustainable solution for Greece, strengthen banking sector and move toward a further integration in the European Union. Moreover, better-than-expected data in the US (especially an encouraging Q3 US GDP report) and China have also contributed to the risk-on mood in financial markets.
- Nevertheless, European Summits still leaves key elements unresolved**  
 Decisions were taken on all fronts, but there are still many details to be sorted out. We are again pending on a tight agenda and a still open negotiation process. G20- meeting, due next week, will bring more news about the support of the IMF and Emerging countries to the measures to contain sovereign contagion.
- Economic data dispelled risk of recession in the short-term, but down side risk remain**  
 US Real GDP growth increased 2.5% annualized showing a stronger-than-expected economic demand. Additionally the Chinese PMI suggested that China manufacturing sector is recovering. However, evidence of the region's export slowdown due to weakening global demand continued to mount this week. Meanwhile, weaker economic data were released in Europe. Our revised MICA GDP indicator for the last quarter of the year foresees stagnation in the Eurozone, rather than recession. All in all, these economic data have helped to reduce fears related to a double-dip global recession.
- Central Banks, cautiously dovish**  
 The ECB is not likely to pre-announce any change in its monetary policy stance for December's meeting given that the ECB has sent signals that they would not act pre-emptively on downside risks to growth as they do in face of upside risks to inflation, and considering that it is Mr. Draghi's first meeting. Meanwhile, weak growth and downside risks favor a more dovish Fed, and the pressure is on for them to act if economic data do not consistently improve. Yet, given that Operation Twist has just begun, we do not expect the Fed to announce QE3 at the next meeting.

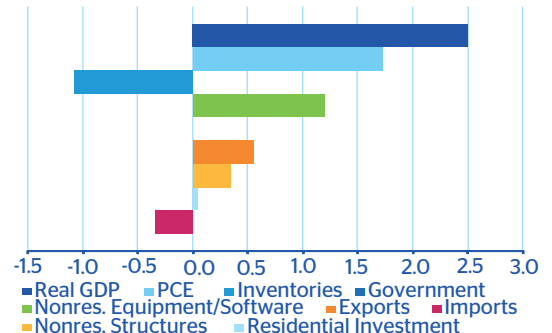
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Chart 1  
**Asian export growth is weakening**



Source: BBVA Research and Bloomberg

Chart 2  
**Contributions to the US real 3Q11 GDP, saar pp**



Source: Bureau of Economic Analysis

## Economic Analysis

**European Summits still leaves key elements unresolved**

Decisions were taken on all fronts, but there are still many details to be sorted out. As regards Greece the EU leaders decided a haircut of 50% to private investors, with credit enhancements by 30 bn euros, to bring Greek debt sustainable at 120% of GDP by 2020. Also remains a closer monitoring and control of Greek reforms, with in-site work of the Commission. In this context, we consider that the Greek problem is not fully solved despite a "voluntary" 50% haircut to investors. Greek debt will be sustainable in theory, but is subject to many shocks and could still face important challenges. Concerning other peripherals, the leaders put pressure on Spain and especially Italy to implement reforms. In Italy doubts will remain open until the political situation is not clarified and reforms are really approved. In Spain the short-term challenge is to fulfill the 6% deficit target. Pressure is also placed on labour market reform and financial sector problems.

As expected, two mechanisms to leverage EFSF up are approved (an SPV and an insurance scheme or bond issuance, with no details) with an expected leverage of 4 or 5 times (around 1 trillion euro). Details are expected to be determined in November

We consider that its firepower is not enough to induce a virtuous cycle of credibility, as would have been the case had this task been taken by the ECB.

On bank recapitalization, leaders decided a 9% minimum core tier 1 capital to be reached before June 2012, where sovereign debt and loans have to be valued at market prices, and additional measures on liquidity to be determined by the EU Commission in the future, such as guarantees for banks' issuance. We think that authorities have not curbed first the perception of sovereign risk in all peripheral countries, which was the underlying problem.

Regarding Governance, leaders took steps ahead towards fiscal integration, but more in the line of increased control than on the line of Eurobonds.

Overall, positive evaluation but a wait and see attitude is warranted, we are again pending on a tight agenda and still open negotiation process.

**Mixed economic reports put pressure on the Fed to act**

The latest economic reports have been mixed, furthering uncertainties regarding the future outlook. GDP data released today suggest stronger growth than previously expected, mainly due to a jump in personal consumption expenditures which ease worries of a double-dip recession. Retail sales jumped last month, indicating better-than-expected consumer activity. However, depressed consumer confidence levels imply more persistent and long-lasting effects of the financial crisis. Despite upward revisions to employment data for Q3, job growth remains slower than in early 2011 and job availability is not enough to decrease the unemployment rate. Manufacturing reports have been conflicting with the ISM suggesting some improvements but regional Federal Reserve surveys noting continued slowdowns in the sector. While some housing data has been better-than-expected, an increase in distressed properties could jeopardize the market. In general, current downside risks facing the US economy will outweigh any potential upside, and both consumers and businesses tend to be pessimistic about economic prospects. We expect that the fourth quarter will be slightly weaker than the third. Weak employment growth and other downside risks (political brinkmanship, slowdowns in Europe, and further deleveraging) will limit significant acceleration in 4Q11.

Weak growth and downside risks favor a more dovish Fed, and the pressure is on for them to act if economic data do not consistently improve. Concerns remain focused on lowering the unemployment rate while keeping inflation expectations in check. Given that Operation Twist has just begun, we do not expect the Fed to announce QE3 at the next meeting. The Fed is likely to rely more on public communications as a policy tool, and the meeting could be an opportunity for them to communicate strategy and options. In general, the Fed will continue to monitor economic data and is prepared to act again if growth prospects significantly deteriorate further.

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## Economic Analysis

**ECB is unlikely to act pre-emptively**

ECB's focus shifted to downside risks to growth over the last two meetings. In fact, reiterated its implicit easing bias, further adapted its wording to pave the way for lower rates if need arises, and even discussed the pros and cons of both leaving rates unchanged and lowering them. Moreover, it seems that the ECB no longer judges that the monetary policy stance remains accommodative as they dropped the phrase and replaced it with "short-term interest rates remain low. The ECB is not likely to pre-announce any change in its monetary policy stance for December's meeting given that the ECB has sent signals that they would not act pre-emptively on downside risks to growth as they do in face of upside risks to inflation, and considering that it is Mr. Draghi's first meeting. Both the dovish tone and the implicit easing bias will be retained; however, Mr. Draghi will likely insist not only on the responsibility of delivering price stability but also on the importance of being credible on the delivery. At the same time, he will reiterate that non-standard measures will continue for as long as needed. In this respect, additional measures are not likely considering the "amplitude" of the decisions taken in October's meeting. Yet, the details of the new covered bond purchase programme (CBPP2) to buy bonds issued by banks and backed by collateral will be released.

**Asian exports continue to trend down**

Evidence of the region's export slowdown due to weakening global demand continued to mount this week with Hong Kong announcing a lower-than-expected September outturn (-3.0% y/y; consensus: +6.5%). The weak performance was due to soft demand from China (-7.3% y/y) possibly due to decreased end-demand elsewhere (Hong Kong sends many raw materials to China, for manufacture and export of finished products) and the US (-8.9%). Exports of electronics and machinery (-7.5% y/y) declined sharply, and September's outturn signaled the first year-over-year contraction since October 2009. The government maintained that the outlook looks 'bleak,' although we believe that exports are set to bottom over the next two quarters, before picking up in mid-2012.

Hong Kong's moderating exports outturns mirror what many other Asian economies have been experiencing since the EU crisis. More recently, downside risks of a severe slowdown have increased. Taiwan is facing similar headwinds as Hong Kong from a faltering global recovery, as exports growth has held below 10% for two straight months. Although Taiwanese exports of information and communication products still grew rapidly thanks to robust global demand for high-end smartphones and tablet computers, overall the electronics component of exports, which accounts for 28% of Taiwan's outgoing trade, moderated significantly in the third quarter, to 3.0% y/y. Earlier this month China warned of 'severe' upcoming challenges to its exports after its September outturn came in below expectations (17.1% y/y, consensus 20.5% y/y). Demand from abroad is likely to remain weak in the short term. Pressure on exports may be even more acute in areas such like Thailand, which is suffering from disruptions due to intense flooding. That said, our view is that while the coming quarter will be challenging for Asia's exporters, robust domestic demand and strong intraregional trade should provide a cushion, and set the stage for an eventual rebound.

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Markets Analysis

Global Interest Rates

Interest Rates Europe and USA

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**Interest Rates: With the EFSF guarantee, what will the new price for peripheral bonds be?**

Turning the EFSF into an insurer that guarantees a percentage of first losses for new bonds issued by countries with problems in accessing the market should foster investor appetite. We acknowledge that this measure is going to provoke market fragmentation, with two types of bonds: i) the old bonds; and ii) the new ones with the credit enhancement. In fact, today's statement opens another alternative by saying that "risk insurance would be offered to private investors as an option when buying bonds in the primary market". Although this could initially create some market distortion in flows due to investors selling old bonds to buy the new ones, this would not be dissimilar to when the GGBs (Government Guaranteed Bonds) were launched to support the banking system three years ago, and in our view the negative consequences are manageable.

We have carried out an exercise to estimate the impact on bond yields assuming 20% protection. The approximation is based on the idea of pricing a portfolio composed of the current bond and a CDS paying off 20% of notional in the event of default.

For instance, a 10-year Spain CDS has a running price of 374bp, which is equivalent to paying 25.50% of the notional upfront for being protected. Assuming a recovery rate of 40%, the upfront premium to be paid to get 20% if Spain defaults is 8.50% of the notional (25.50% x 20% ÷ (1-40%) = 8.50%). Applying the current 10-year benchmark DVO1, the cost of the credit enhancement is 1.17%, so the new yield should be below current yield levels by roughly the amount of this spread.

After carrying out this exercise for the three countries across different maturities, in general the results range between 100bp and 150bp for the spread, with Italy benefiting the most and Belgium the least due to yield levels (see Table 1).

**Credit: EU summit supportive for credit markets**

The measures announced following the EU Summit could be positive for the senior level and lower Tier 2 of EU bank spreads, while the impact on Tier 1 securities will be on a case-by-case basis. A higher capital buffer and increased solvency - ceteris paribus - reduces the probability of default and as such it is supportive for the credit market. Also, we believe that Thursday's EBA statement, which foresees support for long-term funding through the issuance of government-guaranteed debt, may be largely supportive for covered bonds - given the reduced refinancing risk for EU banks.

As a consequence of a deal being reached on the European Sovereign Crisis, the iTraxx Main tightened 20bp, trading at end-August levels of 155bp, compared to 175bp last Friday. The Financial sector benefited the most, with the iTraxx Financial Senior tightening 28bp to 210bp from last week and the iTraxx Financial Subordinated 56bp to 415bp from 471bp last week. Sovereigns also benefited from the rally tightening 40bp to 295bp.

Primary markets remained subdued ahead of the EU Summit and the announcement of various corporate results. We would highlight the issuance of EUR1bn and GBP500mn by the Mexican company America Móvil. The week also has been calm in terms of rating moves with no main action from the agencies.

We expect activity to increase next week as more issuers come out of blackout period and the ECB announces the details of its Covered Bond Purchase Plan.

Table 1

**New bond issuance yield**

Home	Country	10y yield	10y CDS (pb)	10y CDS upfront	20% CDS upfront	10y DVO1	Yield Spread	10y yield adjusted
→	Italian Republic	5.93%	448	29.50%	9.83%	6.80	-1.45%	4.48%
→	Kingdom of Belgium	4.41%	295	21.00%	7.00%	7.80	-0.90%	3.51%
→	Kingdom of Spain	5.51%	374	25.50%	8.50%	7.25	-1.17%	4.34%

Source: Bloomberg and BBVA Research

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## Economic Analysis

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## Calendar: Indicators

## Eurozone: Flash HICP inflation (October, October 31st)

Forecast: 2.9% y/y

Consensus: 2.8% y/y

Previous: 3.0% y/y

**Comment:** We see both headline and core inflation moderating slightly in October, driven by lower energy prices along with a mild deceleration in prices of non-energy industrial goods. Still, there is high uncertainty around the forecast of industrial goods inflation this year, given the limited information available to model the change in seasonality. We continue to expect headline inflation to moderate by the end of the year, driven by favorable base effects in energy prices, and reverting below the ECB target at the beginning of 2012. Regarding core inflation, we expect it to hover around 1.8%-1.9% y/y for the remainder of 2011, moderating somewhat afterwards. **Market Impact:** We see some downside risks to our forecast after the release of German figures. A larger moderation in inflation should be read by markets as further signs to trigger an official rate cut before end-year.

## Eurozone: Unemployment rate (September, October 31st)

Forecast: 10.0%

Consensus: 10.0%

Previous: 10.0%

**Comment:** We expect unemployment rate to have remained stable in September, as observed since the beginning of the year. However, higher uncertainty about the economic performance in coming quarters combined with disappointing activity figures for Q3 and Q4 are weighing on hiring intentions, which are worsening further according to the EC survey, and therefore risks to the unemployment rate will be on the upside in coming months. **Market impact:** Given the lag between growth and employment, we do not see major changes in unemployment, although a worse than expected outcome would increase the concerns about double-dip.

## US: ISM Manufacturing Index (October, November 1st)

Forecast: 52.0

Consensus: 52.3

Previous: 51.6

**Comment:** The ISM Manufacturing Index is expected to show slight acceleration in economic activity compared to last month. Third quarter figures were much weaker than in 1H11, but regional Federal Reserve surveys suggest some improvements in October. Rebounds in production and new orders may suggest a recovery in demand. However, price pressures have been stronger than expected lately and could increase the downside risk to demand expectations. Furthermore, manufacturing employment is not expected to improve much after two consecutive months of declines. **Market Impact:** Although most signs point to moderate expansion in the manufacturing sector, the ISM report could cause some anxiety among markets if it indicates further deterioration in demand conditions.

## US: Nonfarm Payroll and Unemployment Rate (October, November 4)

Forecast: 105K, 9.1%

Consensus: 100K, 9.1%

Previous: 103K, 9.1%

**Comment:** Mixed economic reports in October suggest little improvement in the employment situation and only modest growth in nonfarm payrolls for the month. Despite upward revisions to Q3 data in last month's report, employers continue to announce planned job cuts. Employment data in manufacturing reports have been mixed, suggesting that job growth in the sector will be weak. Furthermore, government layoffs are likely to continue. Initial jobless claims have hovered near 400K but have not dropped below this level since September. Given these labor market trends, we do not expect the unemployment rate to fall. **Market Impact:** Market expectations for employment growth are low, but significantly weak payrolls could turn the tables again toward fears of a rising unemployment rate.

## China: PMI for October (November 1st)

Forecast: 51.7

Consensus: -

Previous: 51.2

**Comment:** Despite recent concerns about the strength of China's growth momentum as external demand weakens, recent activity indicators have been holding up well through September. As an example, the latest flash estimate of the private sector PMI for October (Markit) rose to 51.1 after being in the contraction zone (sub-50), on strong new order and export order components. We expect the official monthly PMI index, which covers a larger sample, to confirm a slight upturn from the previous month. **Market impact:** A lower-than-expected reading could dent sentiment about the growth outlook, while a higher-than-expected outturn, combined with recent signs of policy easing, would further strengthen the outlook.

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## Markets Data

			Close	Weekly change	Monthly change	Annual change
Interest Rates (changes in bps)	US	3-month Libor rate	0.43	1	6	14
		2-yr yield	0.30	3	5	-4
		10-yr yield	2.31	10	34	-28
	EMU	3-month Euribor rate	1.59	1	5	55
		2-yr yield	0.62	-4	2	-37
		10-yr yield	2.18	8	17	-34
Exchange Rates (Changes in %)	Europe	Dollar-Euro	1.416	2.2	4.0	1.8
		Pound-Euro	0.88	1.0	0.9	1.2
		Swiss Franc-Euro	1.22	-0.3	0.1	-10.7
	America	Argentina (peso-dollar)	4.24	0.0	0.7	7.1
		Brazil (real-dollar)	1.70	-4.4	-6.8	-0.1
		Colombia (peso-dollar)	1863	-1.8	-2.6	1.6
		Chile (peso-dollar)	489	-4.7	-4.7	-0.1
		Mexico (peso-dollar)	1313	-3.5	-2.4	6.3
	Asia	Peru (Nuevo sol-dollar)	2.71	-0.5	-2.2	-3.3
		Japan (Yen-Dollar)	75.77	-0.6	-1.0	-5.9
		Korea (KRW-Dollar)	1104.30	-3.8	-5.9	-1.8
		Australia (AUD-Dollar)	1.071	3.7	8.5	9.1
Comm. (chg %)	Brent oil (\$/b)	110.5	0.9	6.5	32.9	
	Gold (\$/ounce)	1744.5	6.2	8.4	28.3	
	Base metals	538.9	1.4	-0.8	-0.7	
Stock Markets (Changes in %)	Euro	Ibex 35	9199	3.9	8.5	-14.9
		EuroStoxx 50	2459	5.2	13.0	-13.6
		USA (S&P 500)	1282	3.5	11.3	8.3
	America	Argentina (Merval)	2991	6.9	19.0	-0.5
		Brazil (Bovespa)	59444	7.6	11.6	-15.9
		Colombia (IGBC)	13566	0.4	5.3	-14.7
		Chile (IGPA)	20557	3.7	9.1	-10.1
		Mexico (CPI)	36974	5.6	10.6	4.0
		Peru (General Lima)	20028	6.2	8.0	4.2
		Venezuela (IBC)	106566	3.1	7.0	57.9
	Asia	Nikkei225	9050	4.3	5.0	-1.7
		HSI	20019	11.1	11.1	-13.3
Credit (changes in bps)	Ind.	Itraxx Main	150	-26	-43	53
		Itraxx Xover	635	-93	-171	178
	Sovereign risk	CDS Germany	71	-19	-33	37
		CDS Portugal	992	-87	-102	614
		CDS Spain	322	-53	-58	107
		CDS USA	36	-5	-16	---
		CDS Emerging	258	-55	-95	53
		CDS Argentina	862	-148	-182	237
		CDS Brazil	134	-29	-57	34
		CDS Colombia	132	-30	-55	32
		CDS Chile	103	-26	-39	35
		CDS Mexico	130	-29	-58	24
		CDS Peru	135	-30	-57	28

Source: Bloomberg and Datastream

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