BBVA | RESEARCH

Weekly Watch
Global

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Economic Analysis

Financial Scenarios
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The Fed maintains its dovish tone

The last FED monetary policy meeting confirmed a very gradual exit strategy after completing the LSAP as planned in 2Q11 (see FED Watch). This cautious Fed monetary policy approach diverges from the ECB's hawkish tone. In fact, the upside surprises in April "flash" HICP inflation (2.8%) increase the probability of a rate hike in June. Next week, the ECB is likely to keep interest rates unchanged at 1.25%, but the bank will maintain a hawkish stance and may even signal that the next hike in interest rates will come in June including the quote "strong vigilance" in its statement. We also expect the BoE to maintain its monetary policy unchanged, supported by recent weak economic data. The increasing risk of overheating in emerging markets has made the regional central banks more willing to allow FX appreciation and to tighten monetary policy, despite headwinds from rising oil prices. We expect India and the Philippines to raise interest rates in their policy meetings next week.

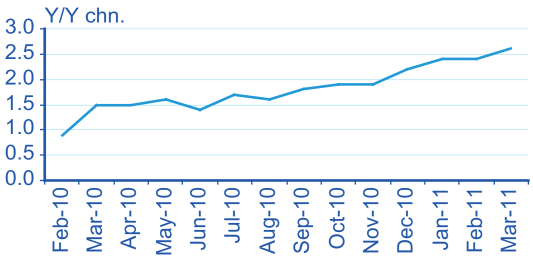
Strong economic momentum in EM while real data remain sound in DM

During this week, the positive outturns in real economic data in DM suggest that economic activity has been quite sound in the first quarter of the year. Nonetheless, the US 1Q GDP grew at slower rate than expected. Furthermore, economic confidence indicators point to some moderation in the pace of growth in the coming quarters, especially in the EZ. Meanwhile, activity and prices data continue to surprise on the upside in EM.

News flow remains challenge for the Peripherals

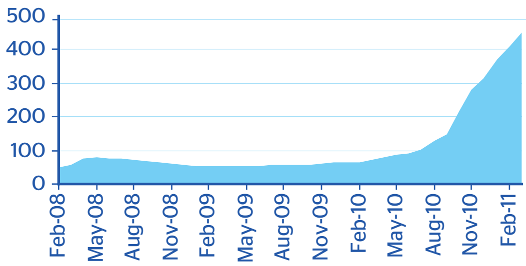
Financial strains have re-emerged in the European periphery. Recent political events in Europe suggest less willingness to support financial aid for these countries. In particular, the Finnish election results have increased the uncertainties about European support for the Portuguese bail-out package, which is expected to be ready for discussion by mid-May. Additionally, markets have been nervous and are pricing in a Greek debt restructuring before the ESM framework enters into effect in 2013, after comments from German officials (including the finance minister) suggesting this possibility. In contrast, ECB's officials have strongly rejected this possibility, signalling the danger of triggering a banking crisis. In our view, this noise will maintain peripheral risk premiums high until the EMU confronts the solvency problems in the peripheral countries. **Next week** April figures for the US ISM, payroll and Chinese PMI index will be the main focus of the markets, together with the ECB Council. We expect the positive trend in these indicators to continue, although at slower pace in the case of the US.

Chart 1
Eurozone CPI Estimates



Source: Bloomberg

Chart 2
Renminbi Total Deposit in Hong Kong



Source: Bloomberg

Highlights

Keeping tabs on the pace of China's RMB internationalization

RMB trade settlement transactions and offshore deposits grow.

The US debt ceiling creates short-term noise...

...but budget proposals made in the past weeks were the first step toward a consolidation.

Strong return of European banks to primary markets

Spanish banks and saving banks have issued more than EUR30bn since the start of the year.

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Markets

Greek risk takes the Euro slope to lows

Comments concerning the potential restructuring of Greek debt have been the main driver of the euro curve in recent weeks. This, together with the limited volume seen in recent days (Easter week) has accentuated the point to which the market is pricing in a potential haircut, taking the Greek 2Y bond to 23%. This has had something of a knock-on effect on other peripheral countries such as Spain and Italy, and a safe-haven effect on the 10Y German bond. Meanwhile, the short ends of curve have been more or less unaffected, and remain more sensitive to price data (the latest inflation figures, for April, were the highest in two years).

In the US, the Treasuries curve has also discounted the safe-haven effect but in a more parallel way, and although rates have corrected by around 20bp the 2Y/10Y slope has remained more or less steady. Bernanke's statement following the latest meeting still reflects a dovish outlook which should keep short ends range-bound, while long ends may become more sensitive to fiscal risk and the debate over extending the limit on debt.

FOMC Statement Suggests Additional USD Weakness Near-term

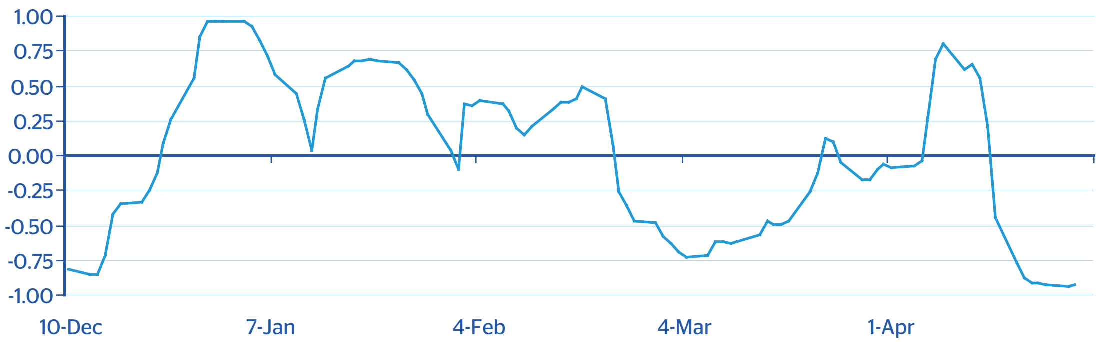
While we continue to see EURUSD lower from here given the market is already exceptionally long of the EURUSD trade and expectations for additional ECB hikes in 2011 appear to be more than fully priced given BBVA only sees one more 25bp hike this year, US – German 10yr spreads have narrowed faster and oil prices have remained higher for longer than we anticipated. These, coupled with the rotation out of traditional carry trade funding currencies in favor of USD's on the back of elevated risk appetite, with minimal hawkish language from the Fed, suggest some risks to our near-term EURUSD forecast. Additionally, unless Wednesday's Fed action sparks a large amount of short-USD profit-taking (something we do not envisage), we would not be surprised to see continued flows into high yielding as well as local market currencies. Clearly within the Latam space, BRL, MXN, COP and CLP have had significant runs of late with little interference from respective domestic regulatory bodies. So long as regulators remain on the sidelines, it appears the Fed will continue to provide ample liquidity allowing carry trades to remain in force, possibly to the USD's chagrin.

Results gaining momentum but the dollar and sovereign risk are "holding back" Europe

The S&P-500 future seems to be testing the long-term resistance at 1,370-1,400 points, led by cyclical sectors (Technology, Consumer and Industrials), due to the combination of three factors: i) the Fed statements which point to at least another 6 months of ultra-low rates; ii) the extremely weak US dollar which is driving corporate earnings in the United States, and; iii) the growing momentum we are seeing in 1Q11 earnings as more companies publish results.

The performance of the EuroStoxx has also been positive, despite the challenge of a weak dollar and increased sovereign risk on the back of additional noise stemming from the potential restructuring of Greece's debt.

Chart 3
Correlation of 2Y/10Y Govt slope and 10Y Greek rate



Source: Bloomberg and BBVA Research

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Keeping tabs on the pace of China's RMB internationalization

As has been well publicized, China has embarked on efforts to internationalize the use of its currency, the RMB (see Economic Watch: RMB Cross-border Trade Settlement). Since the launching of these efforts in 2008, the value of RMB trade settlement transactions and offshore deposits has increased steadily. According to the latest data for 1Q11, the value of RMB cross-border settlement transactions amounted to RMB 360.3 billion, an increase of 13.9% over the previous quarter (see Chart), resulting in an increase in the share of China's trade settled in RMB to 7%, from only 2.5% for all of 2010. Meanwhile, the size of RMB deposits in Hong Kong, the main offshore RMB center, have increased further to above RMB 400 billion in February, having doubled since the third quarter of last year alone (much of which, however, may reflect expectations of currency appreciation rather than use in trade settlement). On the policy front, the authorities are considering a number of steps to deepen the offshore use of RMB further, including: (i) an expansion of the existing pilot program to cover more regions within China (from the current 20 provinces/municipalities); (ii) a facilitation of other offshore RMB centres, especially Singapore; (iii) incentives for the development of additional RMB-denominated financial products in Hong Kong; and most importantly in our view, (iv) a possible easing of restrictions on inflows of RMB for FDI (no details have been announced). RMB bond issuance in Hong Kong is continuing at a steady pace and, for the first time, Hong Kong's stock exchange has played host to an RMB-denominated stock issuance (Hui Xian Real Estate Investment Trust).

The US debt ceiling creates short-term noise

Standard & Poor's threat to downgrade the United States' AAA credit rating last week added more pressure to the already high tensions in the debate between Democrats and Republicans regarding the US budget and debt ceiling. S&P cited "increased risk" that "medium and long-term fiscal challenges" would not be resolved as the cause for the revision to a negative outlook. Indeed, the budget debate and debt ceiling situation are causing a lengthy tug of war between the Democrats and Republicans, but budget proposals made by each party in the past few weeks were the first step toward a possible consolidation. The main difference between the two parties' proposals is that the Republicans' proposal seeks to source cuts from entitlements, while President Obama's proposal seeks to shift more of a burden to wealthy individuals. In general terms, Mr. Obama targets USD4tr in cuts over 12 years, while the Ryan Proposal calls for USD6tr in cuts over 10 years. While political brinksmanship increases the signal-to-noise ratio, we believe that in the long run the process is gravitating towards credible cuts. Regarding the debt ceiling, although politicians may delay a decision by temporarily extending the debt ceiling by small amounts, in the end they will not fail to raise the trigger due to associated turmoil in the markets.

Strong return of European banks to primary markets

A noticeable surge in European banks' issuance has taken place over the last quarter. In particular, some Spanish banks and savings banks took advantage of the window of opportunity following the reduction and stabilization of risk premiums, and have issued more than EUR30bn since the start of the year. Nonetheless, only a select group of Spanish institutions have been able to tap primary markets, which leaves around 40% of the Spanish financial system. This pick in issuance activity for some Spanish institutions has specific characteristics: 1) most of the new issuance revolves around covered bonds which grant more protection for bond holders than senior unsecured debt, 2) the issuance spreads are wide compared to historical spreads, but issuances have been placed at better prices as the quarter has progressed, and 3) the maturities are slightly longer than in previous months. Regarding the rest of the EMU, only the strongest institutions have been able to sell their bonds so far (in line with the situation in Spain), but in some cases with lower prices. Without a doubt, the recent issuance activity will allow institutions to handle the large amounts of debt to be refinanced over this year in a comfortable way. In this context, the positive trend in the markets will remain while sovereign risk is contained, although the markets will continue to be sensitive as there is a risk that some future events may disappoint.

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Calendar: Indicators

Eurozone: Industrial producer prices (March, May 3rd)

Forecast: 0.6% m/m	Consensus: 0.6% m/m	Previous: 0.8% m/m

Comment: Producer prices are expected to increase further in March, but more slowly than in previous months as a result of a moderation in the growth of commodity prices. Nevertheless, industrial inflation should have rebounded in the first quarter as a whole (especially due to the jump in January), and along with more resilient domestic demand, may eventually result in greater indirect inflationary effects than previously anticipated. **Market impact:** A sharp increase in industrial inflation could fuel fears of second round effects that could lead markets to price in tighter ECB monetary policy.

Eurozone: Retail sales (March, May 4th)

Forecast: 0.0% m/m	Consensus: 0.1% m/m	Previous: 0.1% m/m

Comment: We expect retail sales to have remained virtually stagnant in March, resulting in flat growth in Q1 as a whole after the slight decline observed in the last quarter of 2010. These figures suggest that private consumption in the eurozone should have remained weak at the beginning of the year, but showing no clear signs of slowing and thus contributing positively to quarterly GDP growth. **Market Impact:** A sharp drop in retail sales could be interpreted by markets as an increase in uncertainty about the recovery of household spending, especially affected in the periphery by the strong fiscal retrenchment, thus raising doubts about the strength of the upswing. .

US: ISM Manufacturing Index (April, 2nd May)

Forecast: 60.0	Consensus: 59.6	Previous: 61.2

Comment: The July ISM manufacturing index declined slightly from 61.4 to 61.2, marking the twentieth consecutive month that the index has come in above the benchmark of 50. This indicates that the manufacturing industry is continuing to expand, and the current level is the fourth highest level since January 1984. While all sub-indices except inventories point to an expansion, prices show inflationary pressures. Prices rose for the fourth month in a row with the index reaching 85. We expect the ISM Manufacturing index to decline slightly but remain significantly higher than 50. **Market impact:** A significant drop in the ISM Manufacturing index would imply a slowdown in manufacturing indexes in 2Q11 and negatively affect the financial markets.

US: Non-farm Payroll (April, 6th May)

Forecast: 185K	Consensus: 180K	Previous: 216K

Comment: In March non-farm payrolls increased by 216K and since February 2010 the U.S. economy created 1,492K new jobs. While the private sector added 230K jobs, fiscal problems urge local governments to lay off more employees. Since May 2010 the government sector lost 814K jobs. Due to strong employment growth in March, the unemployment rate declined from 8.9% to 8.8%, which is 1.0pp lower than in November 2010. The alternative unemployment rate, which includes those marginally attached to the workforce and working part-time for economic reasons, also declined and reached 15.7% in March. We expect the current positive trend in non-farm payrolls to continue at a slower pace and the rising oil prices to be a threat in the short-term. **Market impact:** If April non-farm payrolls come in significantly lower than market expectations, it would suggest slower economic activity and push equity markets down.

China: PMI (April, 1st May)

Forecast: 54.2	Consensus: 54.0	Previous: 53.4

Comment: The Purchasing Managers' Index (PMI) will be watched for signs of economic overheating, especially after the first quarter's faster-than-expected GDP growth (9.7% y/y) and rising inflation (5.4% y/y in March). We expect the PMI to rise again in April, following an increase in March, which was the first upturn in 4 months. **Market impact:** A higher-than-expected reading would enhance expectations of further monetary tightening measures.

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			Close	Weekly change	Monthly change	Annual change
Interest Rates (changes in bps)	US	3-month Libor rate	0.27	0	-3	-7
		2-yr yield	0.63	-3	-16	-34
		10-yr yield	3.31	-8	-13	-34
	EMU	3-month Euribor rate	1.39	3	15	72
		2-yr yield	1.79	3	3	102
		10-yr yield	3.26	0	-8	24
Exchange Rates (changes in %)	Europe	Dollar-Euro	1.485	2.0	5.1	11.9
		Pound-Euro	0.89	1.2	1.3	2.7
		Swiss Franc-Euro	1.29	-0.1	-0.8	-10.1
	America	Argentina (peso-dollar)	4.08	0.0	0.9	5.0
		Brazil (real-dollar)	1.57	0.5	-3.6	-9.1
		Colombia (peso-dollar)	1769	-0.8	-5.8	-9.4
		Chile (peso-dollar)	460	-1.5	-4.5	-11.6
		Mexico (peso-dollar)	11.54	-0.5	-3.2	-6.1
		Peru (Nuevo sol-dollar)	2.82	-0.2	0.3	-1.2
	Asia	Japan (Yen-Dollar)	81.34	-0.7	-1.8	-13.5
		Korea (KRW-Dollar)	1069.10	-1.2	-2.7	-3.8
		Australia (AUD-Dollar)	1.095	2.0	6.0	18.2
Comm. (chg %)		Brent oil ($/b)	125.5	1.2	9.0	43.5
		Gold ($/ounce)	1543.7	2.4	8.5	30.9
		Base metals	618.9	-1.4	-0.9	21.3
Stock Markets (changes in %)	Euro	Ibex 35	10871	2.7	1.3	3.6
		EuroStoxx 50	3010	2.5	2.5	6.9
	America	USA (S&P 500)	1361	1.8	2.5	14.7
		Argentina (Merval)	3377	-1.1	0.0	40.9
		Brazil (Bovespa)	65879	-1.8	-3.1	-2.4
		Colombia (IGBC)	14424	0.6	0.8	15.3
		Chile (IGPA)	22605	0.7	3.9	25.3
		Mexico (CPI)	36749	-0.2	-1.2	12.4
		Peru (General Lima)	19723	4.9	-9.6	24.5
		Venezuela (IBC)	73785	4.1	3.1	20.3
	Asia	Nikkei225	9850	1.7	1.5	-10.9
		HSI	23721	-1.7	1.1	12.4
Credit (changes in bps)	Ind.	Itraxx Main	97	-2	-6	9
		Itraxx Xover	352	-11	-34	-74
	Sovereign risk	CDS Germany	43	-1	-1	-2
		CDS Portugal	659	0	84	379
		CDS Spain	242	-6	24	83
		CDS USA	45	0	4	---
		CDS Emerging	203	0	-3	-18
		CDS Argentina	590	19	-9	-261
		CDS Brazil	107	-2	-6	-17
		CDS Colombia	102	0	-9	-45
		CDS Chile	60	-1	-3	-24
		CDS Mexico	100	-2	-6	-15
		CDS Peru	164	16	25	43

Source: Bloomberg and Datastream

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