RESEARCH

Weekly Watch

Global

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Economic Analysis

Financial Scenarios
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"Risk-on", but for how long?

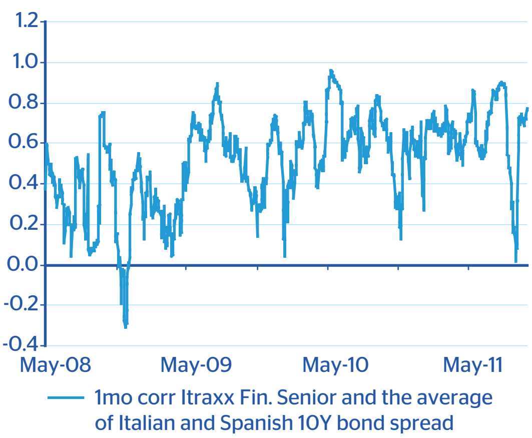
- **"Risk-on" has increased but uncertainties have not disappeared**
  The risk premium has declined slightly this week after increasing strongly in previous weeks. The US picture was more benign this week, while Europe is close to approving EFSF amendments which would increase its lending capacity from €250bn to €440bn, allowing the fund to purchase government debt in the secondary market and recapitalize banks.

- **Europe's next step to restore confidence is leveraging the EFSF**
  The pending increase in lending capacity of the EFSF may not be enough to restore confidence on European countries. The next step is to increase the EFSF's effective lending capacity again, and there are several proposals, such as leveraging the EFSF, using the EFSF fund to guarantee government debt issuances or transforming the EFSF into a bank in order to access ECB funding.

- **ECB: Interest rates (still) on hold and time for new LTROs (up to one year or even longer)**
  The possibility of a cut in the key refi rate next week will be discussed, but in our view they will consider it premature, and the most likely scenario is that the refi rate will remain unchanged. Instead they will concentrate on reducing liquidity constraints by setting longer term refinancing operations.

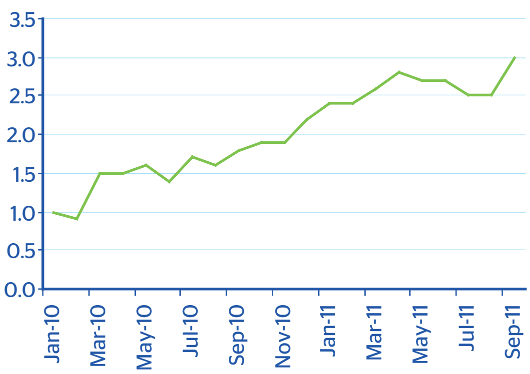
- **Decrease in risk aversion has reduced interventions in EM, but this could prove temporarily**

Chart 1
Positive feedback loop between banks and sovereing



Source: Bloomberg

Chart 2
Eurozone CPI



Source: Bloomberg and BBVA Research

"Risk-on" has increased but uncertainties have not disappeared

The risk premium declined slightly this week after increasing strongly in previous weeks. The US picture was more benign this week, while Europe is close to approving EFSF amendments which increase its lending capacity from €250bn to €440bn, allowing the fund to purchase government debt in the secondary market and recapitalize banks.

Economic data has not fuelled slowdown expectations

US durable goods fell slightly in August, after a strong increase in July, suggesting a better-than-expected outlook for modest growth in the manufacturing sector. Additionally, 2Q GDP was revised upward, driven by increase in non-residential structures, personal consumption expenditure, and net exports. Despite this positive data, other indicators such as new home sales and consumer confidence suggest that underlying economic momentum in the US remains weak. In Europe, economic sentiment fell to 95 in September, a level not seen since December 2009, while the increase in EZ inflation makes it difficult for the ECB to decide on interest rates at its next meeting. In Asia, regional growth is slowing, with industrial production weakening in Japan and Korea, along with lower exports in Hong Kong and Thailand. In LatAm, output growth has deteriorated in recent months, although domestic demand indicators remain resilient, suggesting that inflation pressures remain in place and introducing some risk in current account balance. Next week the US employment report and ISM for September will give a broad view on economic trends in the US. In Asia, trade balances will give us the view of how the slowdown in developed countries is spreading to the continent. Additionally, inflation reports will be released in several Asian countries.

Europe is close to increasing the scope of the EFSF. The next step to restore confidence is to leverage the mechanism

Financial strains have not decreased much this week. The negative links between banks and European sovereigns has not been broken, and this could fuel the financial turmoil affecting the global economy. Pressure on Europe from international organizations and leading countries is increasing. In this context, Europe has taken additional steps to accelerate approval of the EFSF amendments. Twelve of the seventeen euro area member states have approved the strengthening of the EFSF, Germany and Finland among them. Nevertheless, the pending increase in the scope of the EFSF may not be enough to restore confidence in systemic European countries. The next step is therefore to increase the EFSF's effective lending capacity again, and there are several proposals, such as leveraging the EFSF, using the EFSF fund to guarantee government debt issuances or transforming the EFSF into a bank in order to access ECB funding. The first proposal may require credit enhancement improvements and the latter is not easy to implement it in the short-term. The second option is therefore the most likely in our view. The Greek parliament passed the widely questioned and unpopular new property tax, but with a weak majority of 155 to 142, in an effort to secure the next payment from its creditors. The Troika returned to complete the sixth review, but a final decision is not expected before the extraordinary Eurogroup meeting in mid-October. All in all, the new steps put forward by Europe will reduce panic temporarily, but will not restore market confidence.

Home →
Markets →
Calendar →
Markets Data →

ECB: Interest rates (still) on hold and time for new LTROs (up to one year or even longer)

The possibility of a cut in the key refi rate next week will be discussed, but in our view they will consider it premature, and the most likely scenario is that the refi rate will remain unchanged. There are good reasons to discuss a rate cut: recent soft data indicates that macroeconomic conditions have weakened and downside risks to growth have increased significantly due to the euro area sovereign and banking concerns. In this context, there are no risks to price stability. However, taking into consideration how uncomfortable they were with rates at 1%, we expect the council to wait until they collect more information, in particular hard data, before taking such steps. Instead they will concentrate on reducing liquidity constraints by setting longer term refinancing operations. In this regard, although we have in the past played with the idea of re-widening the interest rate corridor by cutting the deposit rate, we think such a step is more likely to be taken at the time of an eventual refi rate cut. The (implicit) easing bias hinted by the ECB in the previous meeting will remain in the statement next week, and could even be made more explicit (downward bias on inflation), signalling they are ready to act in the near future (and making it easier to implement a cut for the new president, Mr. Draghi),

In order to address the issue of long-term funding for banks, and considering the bumpy road ahead for the resolution of the debt crisis (and its spill-over to the banking system), the ECB will very likely reintroduce the 12-month LTRO and discuss the possibility of opening auctions for even longer maturities.

“Risk-on” has reduced interventions in EM, but this could prove temporary

As a result of some relaxation in risk premiums, risky assets have outperformed this week. Pressures on EM have eased, reducing the need for forex intervention in LatAm countries. Nevertheless, risk aversion remains and the risk of forex intervention has not disappeared.

Home
Markets
Calendar
Markets Data

Markets Analysis

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Markets

Interest Rates: Optimism... but it is limited

The improvement in risk appetite this week has led to a rise in euro rates, which saw a change of trend following Wednesday's publication of the German CPI which beat expectations. Initially, expectations that the ECB will cut its official rate at the October meeting (which was at one point priced in with a 100% probability) were anchoring rates, resulting in bear flattening. Following the release of the inflation data, which came in above the ECB target, these expectations adjusted, with the most marked upwards movement at the short end of the curve (bear steepening).

In the coming days, although we expect to continue to see a high level of correlation between the level and slope of the curve, the upward movement may tail off. On one hand conditions remain very volatile, and any relevant comments may again lead to some pessimism (which would accentuate a readjustment of positions following the upwards movement of the last week), and on the other hand factors such as the end of the month and quarter may lead to buying of bonds to adjust portfolios.

Forex: FX market remains cautious despite the improvement in expectations for Europe

This week the FX market did not reflect an increase in risk appetite. Worries about future global growth seem to be influencing FX market sentiment more than the uncertainties about the European debt crisis. In the G10 FX space, EUR was the most favoured against the USD (appreciating by circa 0.75% up until Thursday) although movements were rather subdued on the whole. CHF and JPY showed mixed performance, together with high beta currencies. The same behaviour was observed in EM currencies, with no clear trend in either Asian or LatAm currencies.

Credit: Improving mood on credit markets

Sentiment was positive this week following an IMF and World Bank policy meeting with central bank representatives and finance ministers over the weekend. Reports that the ECB will re-establish its previous covered bond repurchase programme and that it will significantly extend its provision of liquidity to banks led to an overall tightening in spreads and subsequently improved primary market activity in financials, covered bonds and corporate. The week is closing even more positively after the German parliament ratified the expansion of the European Financial Stability Facility (EFSF) on Thursday and the return of the troika of international lenders to Greece, to oversee the country's austerity reforms.

Primary markets have been dominated by French names such as Areva SA (EUR500mn), Peugeot SA (EUR500mn), Casino Guichard (EUR600mn), Saint Gobain (EUR1750mn), Unibail (EUR500mn), Autoroutes du Sud (EUR500mn) and the inaugural covered bond issuance by Crédit Mutuel Arkéa (EUR500mn) in addition to a tap issuance from Caisse de Refinancement de L'Habitat (EUR450mn).

The iTraxx Financial Senior tightened 39bp from its high of 303bp last week to 264bp and the iTraxx SovX tightened 22bp from the high of 359bp last week to the current level of 337bp. This led to an overall tightening of 4bp in the iTraxx Main from 200bp last week to the current level of 196bp.

The week has been relatively calm in terms of rating moves, the noteworthy actions being: Fitch's affirmation of its BB+ ratings on PSA and Renault and downgrade of Telefónica (+23bp) from A- to BBB+, bringing it into line with the other agencies, and Moody's review for downgrade of Unicaja's unsecured debt (A1) and covered bond (Aaa) ratings.

We remain cautious with regard to this mood of renewed confidence and will continue to monitor the credit markets' fundamentals.

Home →
Highlights →
Calendar →
Markets Data →

Economic Analysis

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Calendar: Indicators

Eurozone: Retail sales (August, October 5th)

Forecast: -0.4% m/m	Consensus: -0.3% m/m	Previous: 0.3% m/m

Comment: we expect retail sales to have declined in August, offsetting most of the unexpected increase observed in July. Still, these figures reveal some positive news as the July-August average suggests that retail sales have remained flat in Q3, after falling in previous quarters, especially in Q2. Overall, hard data suggest that the fall in private consumption recorded in Q2 should be temporary. In contrast, consumer confidence shows further evidence of increasing concerns about the economic outlook in coming quarters, which could put a brake on household spending. **Market impact:** a sharp fall in retail sales could be read as further evidence of another quarter with very weak growth, increasing fears about a double-dip in the eurozone.

Germany: Industrial production (August, October 7th)

Forecast: -1.6% m/m	Consensus: -1.5% m/m	Previous: 4.0% m/m

Comment: industrial production is expected to have declined significantly in August, after the surprisingly strong increase in July, which was mainly due to technical factors. The fall in industrial orders also points in the same direction, especially the decline in foreign orders as a result of the slowdown in the global demand recovery. Overall, given the strong correlation between industrial output and the economic cycle, July-August data points to a rebound in quarterly GDP growth in Q3, after being virtually flat in Q2. However, it is worth noting that soft data continues to paint a less optimistic outlook. **Market Impact:** disappointing figures on industrial production should increase market fears about the fragility of the recovery, as global demand is expected to slow further, while domestic demand is not taking the lead of the recovery.

US: ISM Manufacturing Index (September, 3rd)

Forecast: 51.0	Consensus: 50.3	Previous: 50.6

Comment: the ISM Manufacturing Index is expected to show only modest improvement in September with few signs of ongoing improvement in economic activity. In August, the index fell to its lowest point since the recession officially ended two years ago. This month, regional Federal Reserve surveys have indicated pessimism in the business outlook, and weak employment data will likely prevent the sector from growing at an accelerated pace. Although the index has declined for the past three months, the above-50 readings continue to suggest slight economic expansion in the manufacturing sector. **Market Impact:** markets have already priced in weak manufacturing reports for September, however a below-50 reading for the ISM index could cause some anxiety.

US: Non-farm Payroll and Unemployment Rate (September, 4th)

Forecast: 60K, 9.1%	Consensus: 56K, 9.1%	Previous: 0K, 9.1%

Comment: significant improvements in the employment situation are not in the cards for September; however, we do expect a positive change in non-farm payrolls. Last month saw no growth in the jobs market, with weakness in the government sector dragging down the report. In addition, anaemic housing demand will likely impact construction hiring. While the labour market continues to struggle, with only the private sector keeping it afloat, we expect the unemployment rate to remain unchanged. **Market Impact:** months of discouraging employment reports have caused markets to become very sensitive to weak economic data. Any signs of growth in the labour market could be a temporary sigh of relief after a shocking halt to hiring last month.

Korean exports for September (y/y, %)

Forecast: 27.6% y/y	Consensus: 27.6% y/y	Previous:25.9% y/y

Comment: Korean exports are the first monthly release for the region and closely watched as a bellwether given Korea's important place in global supply chains. Exports from Korea have so far have been relatively resilient, with demand from emerging markets offsetting weaker demand in developed economies. Going forward, we expect export trends to soften due to the global slowdown, although in year-on-year terms for September exports should hold up well due to base effects. Also, the won's recent weakening should help exporters to maintain their competitive edge. **Market Impact:** a lower than expected outturn could weaken sentiment about Asia's growth outlook and in the short turn could lead to further currency weakness in Korea and the region.

Home →
Markets →
Highlights →
Markets Data →

Markets Data

			Close	Weekly change	Monthly change	Annual change
Interest Rates (changes in bps)	US	3-month Libor rate	0.37	1	5	8
		2-yr yield	0.25	4	6	-16
		10-yr yield	1.92	9	-30	-59
	EMU	3-month Euribor rate	1.55	2	1	61
		2-yr yield	0.54	15	-18	-31
		10-yr yield	1.88	14	-34	-40
Exchange Rates (changes in %)	Europe	Dollar-Euro	1.343	-0.3	-6.8	-2.3
		Pound-Euro	0.86	-1.2	-2.6	-0.8
		Swiss Franc-Euro	1.22	-0.3	5.0	-9.3
	America	Argentina (peso-dollar)	4.21	0.0	0.1	6.1
		Brazil (real-dollar)	1.86	-0.3	17.2	10.3
		Colombia (peso-dollar)	1930	1.5	8.4	7.4
		Chile (peso-dollar)	523	1.2	13.6	8.9
		Mexico (peso-dollar)	13.81	0.4	12.1	9.9
		Peru (Nuevo sol-dollar)	2.77	0.1	1.7	-0.6
	Asia	Japan (Yen-Dollar)	76.98	0.7	0.6	-7.7
		Korea (KRW-Dollar)	1180.85	1.2	10.9	4.8
		Australia (AUD-Dollar)	0.972	-0.6	-9.3	0.2
Comm. (chg %)		Brent oil ($/b)	103.0	-0.9	-10.3	23.0
		Gold ($/ounce)	1618.9	-2.3	-11.3	22.7
		Base metals	538.5	-1.0	-5.8	1.7
Stock Markets (changes in %)	Euro	Ibex 35	8498	6.3	-2.5	-18.7
		EuroStoxx 50	2176	7.4	-5.5	-20.4
	America	USA (S&P 500)	1145	0.8	-6.0	-0.1
		Argentina (Merval)	2488	0.2	-16.1	-6.2
		Brazil (Bovespa)	52746	-0.9	-6.6	-24.9
		Colombia (IGBC)	12856	-0.9	-4.2	-12.5
		Chile (IGPA)	18711	1.8	-8.6	-16.4
		Mexico (CPI)	33382	2.4	-6.5	-1.3
		Peru (General Lima)	18409	-2.1	-11.1	1.4
		Venezuela (IBC)	99611	-1.0	-0.4	49.5
	Asia	Nikkei225	8700	1.6	-2.8	-7.5
		HSI	17592	-0.4	-14.3	-21.3
Credit (changes in bps)	Ind.	Itraxx Main	190	-7	37	81
		Itraxx Xover	793	-47	146	288
	Sovereign risk	CDS Germany	107	-2	32	69
		CDS Portugal	1082	-76	164	684
		CDS Spain	372	-43	14	145
		CDS USA	52	-2	3	---
		CDS Emerging	350	-17	88	130
		CDS Argentina	1055	21	282	316
		CDS Brazil	188	-20	45	76
		CDS Colombia	188	-24	47	74
		CDS Chile	148	5	52	76
		CDS Mexico	188	-26	45	69
		CDS Peru	192	-25	41	75

Source: Bloomberg and Datastream

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