BBVA Research

Global

Weekly Watch

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Economic Analysis

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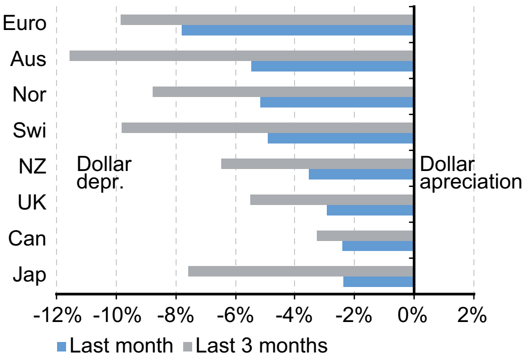
Consensus not reached yet on FX...

Movements in the currency markets are still lead by the different approaches on monetary policy. A clear example of this behaviour is that the FOMC minutes revealed a high consensus on the decision of increasing purchases of assets as soon as possible. Bernanke's speech today hinted that the FED is ready to provide additional accommodation, but in a gradual way to monitor the potential cost and risk of this type of policy. On the other side, public statements of some ECB´members (the "hawks") commenting on the poor effectiveness of certain non standard liquidity measures along with new rules established this week by the ECB which toughen access to liquidity offered by the ECB to certain financial institutions, suggest that the European monetary authority remain bias to a process of phasing-out non standard measures. Additionally during the FMI meeting the world powers couldn't reached a consensus regarding currencies and so, unless new relevant events take place or present situation gets significantly worse, things will probably stay just as they are for a while; with a weak US dollar, strong Euro and further intervention by emerging countries authorities in order to stop appreciation pressures.

… and EM are still worried about appreciation pressures

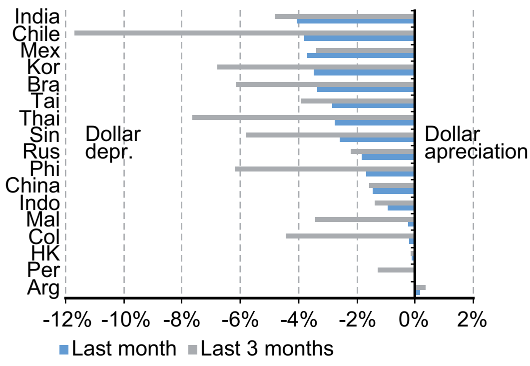
EM are concerned about the strong appreciation on their currencies triggered by the reduction of global risk aversion and the prospects of implementation of the QE in US. In this context, interventions in currency markets have extended across emerging economies. Asia clearly is intervening strongly, specifically Thailand increased withholding tax on foreign investment in government bonds this week. In Latin America Brazil's government raised its financial-operations tax (IOF) to 4% from 2% this month. This trend of increasing interventions would continue in the months to come if appreciation pressures on EM continue.
In the coming week 3Q GDP in China will be released. In the Eurozone and in Germany October PMI and IFO business expectations will be published. In the US the Beige Book will highlight a deceleration growth.

Chart 1
FX rate changes against US dollar: Developed countries (in %)



Source: Datastream and BBVA Research

Chart 2
FX rate changes against US dollar: Emerging countries (in %)



Source: Datastream and BBVA Research

Highlights

FED Strategy

FED members seem committed to implement a new asset purchase program, mainly buying treasuries. The objective is to manipulate the term structure until liquidity trap threat is removed.

China: Rapid credit growth leads to another RRR hike

China's PBoC was reported this past week to have raised the required reserve ratio (RRR) for six major commercial banks by 50 bps, on a two-month temporary basis. It is the first RRR hike since last May, bringing the RRR for the large banks to 17.5%.

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Markets

Expectations of abundant global liquidity are holding up valuations of different assets

In the middle of a period of rises in equity (almost 4% since the start of October), commodities (oil breaching USD85/barrel), and even credit markets, the long ends of curves, far from rising, have remained stable at the bottom of their range (very close to 2.40% in the US 10Y Govt and 2.30% in the Euro 10Y Govt). A more detailed analysis of these rates may well show that they are set to continue. In the case of the US, real rates have continued to fall towards new lows (now below 0.40%), whilst the implied price expectations have undergone something of a rise towards the 2% zone (40bps in 15 days).

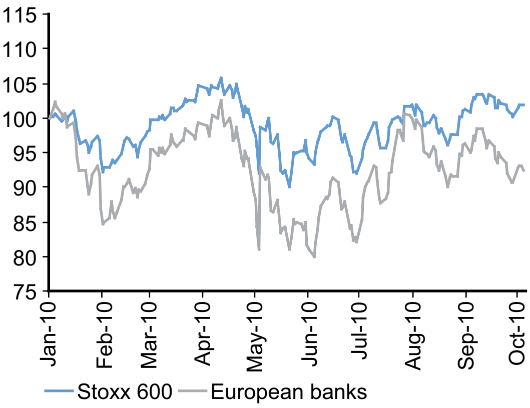
In equity markets, positive mood but still waiting for banks

The start of the 3Q10 earnings season in the US has been promising, reinforcing our view that the results will be good, and management teams have talked of strong demand from emerging markets, encouraging good traffic in the US (above all cars, although construction materials have performed badly), increased sales/earnings forecasts…in other words the perfect combination under current circumstances, for equity to head to annual highs towards the end of the year. However, without the support of banks, it will be difficult, due to their sizeable weighting in indices and because, in qualitative terms, they are very important. The sector is currently being dragged down in the US by the procedure for repossessions on mortgages which has some gaps in many cases, and in Europe, by Basel III once again. In fact, Standard Chartered's EUR3.3bn rights issue has set off rumours of capital raising at other banks. In principle, banks have until 2019 to comply with the new capital ratio requirements (minimum core capital of 7% and an additional cushion for large entities of 2%). However there is much speculation regarding the reasons behind this: 1) the British regulator, and its Swiss counterpart, may impose a stricter timetable than Basel III and bring forward its own deadline; 2) to amortize hybrid capital which does not meet Basel requirements; 3) to maintain a high growth rate and; 4) high exposure to emerging markets which would add some weighting to risk coefficients.

Credits spreads continue to tighten

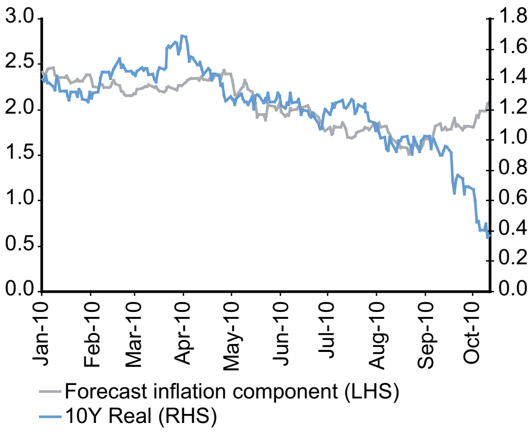
In the last week credit markets performed strongly, with financials outperforming corporates and subordinated financial debt outperforming senior debt. Apart from QE, the drivers behind this were: i) a buoyant primary market with new issues tightening after the launch; ii) sound 3Q10 results from JP Morgan; and iii) the softening of the sovereign risk, with the SovX tightening by 12bps in the week to 141bps.

Chart 3
Stoxx 600 vs Europan Banks Market Performance (100 index=January-2010)



Source: Bloomberg

Chart 4
10Y Govt Rates in the US: Real Rates vs. Inflation



Source: Bloomberg

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Highlights

FED Strategy

The minutes of the last FOMC meeting reveal an agreement between most of the members of the committee for a large-scale asset purchase. The acts point out that the actual economic growth is not enough to increase employment. Also the committee signaled the important role of inflation expectation for lowering the real interest rate and stimulating the economy. In our opinion, the Fed´s main objective is to reduce the term premium in order to lower financing costs across the entire economy, thereby recalibrating risk and boosting aggregate demand. The term premium is the additional return investors require over and above expected future short-term rates for accepting a fixed long-term yield. If enough duration risk is removed from private sector hands, the term premium will decline and investors will shift to other assets, helping to avoid the liquidity trap. Regarding the size and implementation, it seems clear that this represents a big challenge for the Fed (see Bernanke´s speech). In our view, the implementation will 1) be relatively continuous but small steps, 2) be conditional on the evolution of economic forecast, 3) demonstrate persistence for lasting effects and 4) incorporate flexibility in asset choice (purchases will commence with Treasury bonds with a higher concentration in the 5 to 10 year range). Concerning the size, it is likely that the Fed announce be high enough to dispel doubt about its effectiveness in achieving Fed targets. This is important in the context of a possible loss of governance if the Democratic Party loses its power in the House after the November mid term elections, as some recent polls point out; and also considering that the shock to confront in the current juncture is not a financial shock, but a real (more prolonged) one. The Fed would announce a final target number (around $1 tr.) and will likely continue the patterns of preannounce monthly goals. We are considering a gradual implementation of the QE2 that is a monthly intervention of around $65bn. This would leave room for maneuvering in case the policy must be reversed. Lastly we think that the market will closely monitor the impacts of this new QE. In order to maintain market confidence, we need to see increases in the confidence index during the first quarter of 2011 and some improvement in inflation expectations, credit and unemployment over the second quarter. Remember that, even if the main purpose of the Fed is to avoid a tail risks scenario, quantitative easing policy is not free of risks and shocks. For further information, see FED Watch.

China: Rapid credit growth leads to another RRR hike

China's PBoC was reported this past week to have raised the required reserve ratio (RRR) for six major commercial banks by 50 bps, on a two-month temporary basis. In our view, this measure is more of a fine-tuning measure to ease credit growth, than a change in policy direction. September new loans turned out higher than expected, at RMB 595.5 bn (consensus: RMB 500 bn), but the government's overall loan ceiling target remains achievable in our view. A batch of data on September trade and foreign exchange reserves were also released this past week showing a deceleration in import and export growth and a slight narrowing of the trade surplus (USD16.9 bn, compared to USD 20.0 bn in August). Foreign exchange reserves surged to USD 2.65 tr at the end of September, on a combination of factors including the trade surplus, valuation effects from USD depreciation, and capital inflows, which have likely accelerated on expectations of RMB appreciation. The rise in reserves has further intensified international pressure on China for faster currency appreciation. According to our estimates based on data on foreign exchange reserves and FDI, September portfolio inflows amount to USD 75.5 bn. Taking into account valuation effects, net portfolio inflow was USD 33.1 bn in September. As indicated by the surge in foreign exchange reserves, portfolio inflows have accelerated in Q3, mainly due to the anticipation of RMB appreciation. In line with this, FDI inflow in Q3 was USD 105.8bn, compared to USD 28.0 bn in Q2 (September FDI, up 6.1% y/y). Rapid capital inflows may be one factor for the central bank's decision to raise the required reserve ratio for six major banks in order to prevent asset bubbles and help contain inflation. Looking forward, we will be watching closely for an additional batch of data due next week, on Q3 GDP growth, and September inflation, retail sales, industrial production and fixed assets investment.

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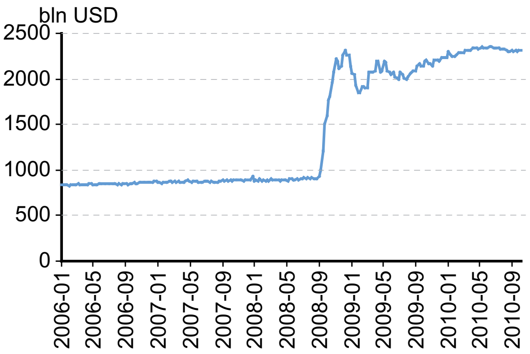
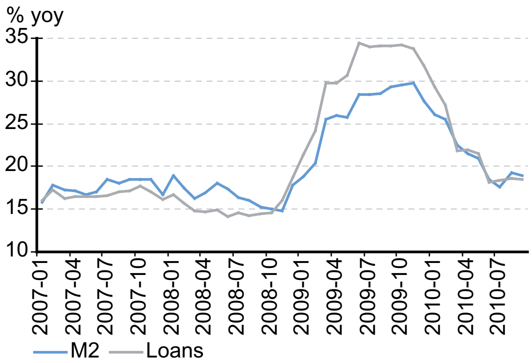
Chart 5
FED Balance sheet: Total Assets



Source: BBVA Research

Chart 6
China: Credit growth



Source: BBVA Research

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Calendar: Indicators

Eurozone: Flash PMI Composite (October, October 21st)

Forecast: 53.2	**Consensus:** 53.6	**Previous:** 54.1

Comment: PMI index is expected to decline again in October, following the significant fall recorded in September and after having been very high in previous months. Despite the expected fall, the index will remain well above the threshold that signals economic activity expansion, but suggesting that the pace of the recovery could slow further in Q4. The fall of the index should reflect a further deterioration in both the manufacturing and service components. **Market Impact:** As the first indicator that reveals information about the evolution of the eurozone economy in Q4, and after the large fall recorded in September, a larger decline than expected could adversely affect the markets.

Germany: Ifo business expectations (October, October 22nd)

Forecast: 102.5	**Consensus:** 102.7	**Previous:** 103.9

Comment: We expect the Ifo business expectations to continue the downward trend observed since July, showing a clearer sign that the German economy will slow in coming quarters. However, the component on the current situation is expected to remain relatively stable or decline only slightly to the extent that firms continue to be upbeat by the extraordinary and recent surge in economic activity. **Market Impact:** A sharp drop of expectations would increase the concern about a more pronounced slowdown in the German economy, and thus in the eurozone as a whole, although some decline is partly discounted after the unexpected strength in expectations observed in recent months.

US: Industrial Production (September, October 18 th)

Forecast: 0.3%	**Consensus:** 0.3%	**Previous:** 0.2%

Comment: Industrial production has been increasing for the last 14 months, yet its pace is slowing down which suggests a more moderate pace of industrial activity going forward. Industrial production rose only 0.1% in August. Furthermore, capacity utilization increased by 0.1pp to 74.7%. Mining and utilities sectors continue to work at higher capacity (86.3%) than manufacturing (72.2%) sector. ISM manufacturing index and regional Fed manufacturing indices also point to similar trends in September. Therefore, we expect industrial production to increase only moderately in September. **Market impact:** A significant drop in industrial production would increase the probability of a second round of quantitative easing.

US:Fed's Beige Book (October, October 20 th)

Comment: The last Fed's Beige Book indicated most districts reported that sales of automobiles and light trucks stabilized and consumer spending increased in August. Retailers' inventory management remained tight but shipping and transportation sectors expanded. The report also showed increase in manufacturing activity but not acceleration. According to the report, businesses are reluctant to expand which negates their need for extensive commercial and industrial loans. We expect that the coming Beige Book report would highlight continued growth but with deceleration across the US. **Market impact:** A negative outlook for regional economies would pile pressure on the FOMC members to take action against economic slowdown.

China: Real GDP (Q3, October 21 st)

Forecast: 9.0% y/y	**Consensus:** 9.5% y/y	**Previous:** 10.3% y/y

Comment: GDP growth is expected to have moderated further in Q3, on signs that tightening measures are working to cool the economy toward a soft-landing. Recent economic indicators, however, point to a pick-up, and there is upside risk to our previous Q3 projections. We continue to expect a soft landing as the authorities appear intent on keeping a lid on rapid credit growth and housing price increases, as witnessed by the latest increase in reserve requirement ratios and intensification of property sector measures. **Market impact:** Q3 GDP will be accompanied by new data on industrial production, retail sales, and urban fixed asset investment. A higher-than-expected Q3 reading may trigger worries over further tightening measures.

Brazil: Official Interest Rate - SELIC (September, October 20th)

Forecast: 10.75%	**Consensus:** 10.75%	**Previous:** 10.75%

Comment: There is a generalized consensus that SELIC rates will be left unchanged at 10.75% till the end of the year. The main uncertainty is whether the SELIC will remain constant throughout 2011 (BBVA's call) or will be adjusted upward to moderate inflation pressures (markets' call). **Market Impact:** Markets will watch the wording of the communiqué, and especially the minutes of the monetary policy meeting to be released on October 28th, for any hints on the length of the monetary stability and for any comments about the exchange rate appreciation.

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				Close	Weekly change	Monthly change	Annual change
Interest Rates	(changes in bps)	US	3-month Libor rate	0.29	0	0	1
			2-yr yield	0.35	1	-12	-60
			10-yr yield	2.54	14	-22	-88
		EMU	3-month Euribor rate	0.99	2	11	25
			2-yr yield	0.80	2	-1	-61
			10-yr yield	2.36	10	-12	-93
Exchange Rates	(changes in %)	Europe	Dollar-Euro	1.400	0.6	7.1	-6.0
			Pound-Euro	0.87	0.2	4.5	-4.0
			Swiss Franc-Euro	1.34	0.4	1.2	-11.5
		America	Argentina (peso-dollar)	3.95	-0.2	0.0	3.4
			Brazil (real-dollar)	1.66	-0.4	-3.0	-2.6
			Colombia (peso-dollar)	1808	1.2	-0.1	-1.7
			Chile (peso-dollar)	479	-0.6	-3.7	-12.6
			Mexico (peso-dollar)	12.46	0.1	-3.1	-4.7
			Peru (Nuevo sol-dollar)	2.79	0.2	0.2	-2.2
		Asia	Japan (Yen-Dollar)	81.44	-0.6	-5.0	-10.4
			Korea (KRW-Dollar)	1113.03	-0.2	-4.5	-5.5
			Australia (AUD-Dollar)	0.989	0.4	5.8	7.9
Comm.	(chg %)		Brent oil ($/b)	83.6	-0.5	6.5	8.6
			Gold ($/ounce)	1366.2	1.4	7.1	29.7
			Base metals	542.9	1.7	5.0	26.0
Stock Markets	(changes in %)	Euro	Ibex 35	10811	0.8	0.9	-7.4
			EuroStoxx 50	2833	1.7	1.7	-2.1
		America	USA (S&P 500)	1169	0.4	4.0	7.5
			Argentina (Merval)	2731	1.2	11.6	23.7
			Brazil (Bovespa)	71494	1.0	5.7	8.0
			Colombia (IGBC)	15464	1.5	9.8	41.3
			Chile (IGPA)	22245	1.1	-1.1	37.4
			Mexico (CPI)	34832	1.1	5.4	13.4
			Peru (General Lima)	19506	3.5	17.1	26.3
			Venezuela (IBC)	66231	-0.1	1.4	28.7
		Asia	Nikkei225	9500	-0.9	-0.1	-7.4
			HSI	23758	3.5	9.5	8.3
Credit	(changes in bps)	Ind.	Itraxx Main	101	-1	-6	15
			Itraxx Xover	462	-6	-10	-59
		Sovereign risk	CDS Germany	33	-4	-8	13
			CDS Portugal	373	-26	33	322
			CDS Spain	201	-18	-29	134
			CDS USA	41	-5	-6	---
			CDS Emerging	194	-4	-41	-61
			CDS Argentina	694	-10	-74	-332
			CDS Brazil	93	-6	-21	-26
			CDS Colombia	94	-7	-26	-53
			CDS Chile	77	2	-6	1
			CDS Mexico	100	-3	-25	-48
			CDS Peru	97	-5	-20	-29

Source: Bloomberg and Datastream

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