

Global

Weekly Watch

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Economics Analysis

Financial Scenarios

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EMU fights back, but markets demand facts

EMU countries finally agreed on an impressive support package. Overall, the program seems solid, both for the short term and as a more permanent tool for maintaining fiscal discipline. The first practical implication is also positive: Spain and Portugal are taking decisive actions to cut their deficits. However, given the lack of credibility of previous European efforts, it may take the effective implementation of measures and hard data to restore market confidence. This week's checkpoint is the presentation of fiscal programs for Spain and Portugal to the ECOFIN on Tuesday, where we anticipate a unanimous European approval.

No signs of double dip so far

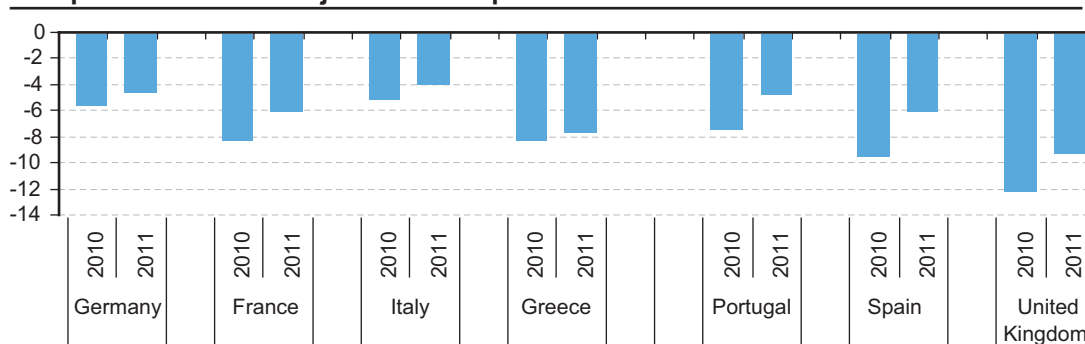
US and (surprisingly) EMU data came mostly on the strong side this week. Hard indicators so far do not show any impact of financial risks on real activity. This week, European PMIs will be useful to gauge if confidence holds up too despite sovereign woes.

Concerns on EM inflation, but pressures are not widespread

China's upward surprises in inflation suggest overheating risks may be increasing. Fortunately, price pressures are not widespread. In Latin America, concern is limited mostly to Brazil, where we will have inflation data. On the other side of the spectrum, Banxico can afford to maintain rates this week, given good inflation data in April.

Chart 1

European countries: Projected deficit plans



Source: National Governments and BBVA Research

Markets



Highlights



Calendar



Markets Data



Highlights

Eurozone: much more liquidity, for longer

The turnaround in ECB policies will probably maintain ample liquidity in the system for a long time, regardless of implementation issues. Downward pressure on short-term rates will result.

Eurozone: fiscal adjustment, a positive driver for sovereign risk

Spain and Portugal fiscal measures are overall well designed and give stronger credibility to the announced path for deficit reduction, which should go a long way to limiting contagion risks in the future.

China: overheating risks increasing, but still manageable

Recent data show that the expansion in China (and the rest of Asia) is gaining momentum. As a consequence, overheating risks are increasing, but they should be manageable with quantitative measures expected.

Markets doubt the ability of governments to deliver

Markets went through the full spectrum of moods last week. The initial efforts by European authorities were cheered with renewed optimism. On bonds, the positive impact of the European program was strong and clear across countries, with Greek 2-year bonds trading below 6% at some points. But the recovery in confidence was never complete. First, trading volumes remained thin for most of the week, with investors trying to guess what role were central banks playing in driving yields. Second, the Euro never really took off, and despite some gains after the program, it became clear quite early that demand for Euro assets was not at the levels expected (more on this below). As the week advanced, investors' optimism shifted to skepticism. In fact, significant announcements on the fiscal front offered by the Spanish and Portuguese government were received with a muted impact, confirming that markets have raised their expectations, after several months in which measures were lacking in implementation and detail. In the final days of the week, skepticism turned into fear as the first cracks in the European position began to appear, with sharp falls in stock markets and widening of bond spreads. One week later, markets are back to square one: doubting the ability of European governments to deliver the fiscal adjustment and institutional reform that the situation calls for. These doubts are exaggerated, as we think the European strategy (strong support, plus strong fiscal adjustment) offers a solid pillar for the medium term, but volatility is the price to pay for too many months of delaying necessary action.

A weak euro is here to stay

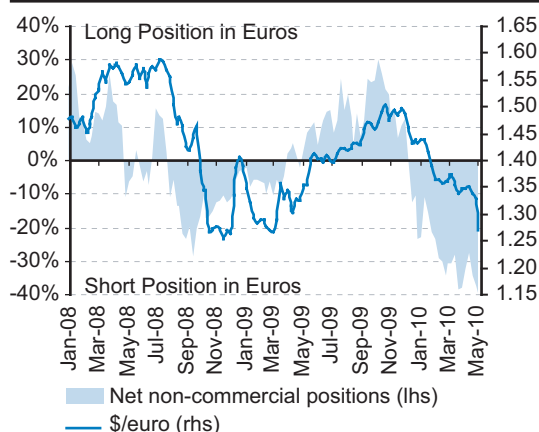
The euro took on the role of victim of the sovereign crisis as its steady depreciation against USD continued, trading at some points below \$1.25, an 18-month low. This reflects the implementation concerns commented in the previous lines, but also that markets price the inability of European institutions to deal with crisis situations, as evidenced by event in the last months. Moreover, cyclical differentiation is playing a key role, as sluggish European growth is lagging behind US performance, and the Euro is logically (in macro terms) a flexible element to give some push to EMU growth.

After contagion, growth takes leading role in Emerging Markets

Despite strong volatility, the story in emerging markets is again a decoupling one, with strong growth in Asia and some Latin American becoming the driver for market movements. Overheating concerns resulted in negative stock market reaction in China, but over the week most of the exchanges ended with strong gains. Also, investors are pressing for currency appreciations and raising the stakes for monetary policy tightening. The Embi Index decreased by 50 bp and some currencies, as the Colombian peso, the Mexican peso, and the Brazilian Real appreciated more than 3%.

Chart 2

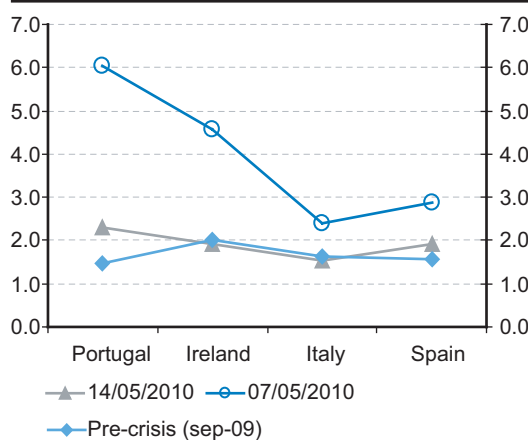
Net non-commercial futures positions in euro



Source: CFTC and Bloomberg

Chart 3

EMU countries: 2yr yield curve



Source: Bloomberg and BBVA Research

Highlights

ECB: much more liquidity, for longer

Contrary to its initial stance and in view of the exceptional circumstances prevailing in European markets, the ECB decided to conduct interventions in the euro area public and private debt securities markets, to adopt 3 and 6-month LTROs with full allotment and to activate temporary liquidity swap lines with the Fed. The 6-month LTRO held on May 12th came out below expectations as the ECB finally allotted €35.7 bn. However, Eonia 1-year swaps broke the 0.5% barrier, suggesting participants expect that liquidity will remain high for a long time, and also in line with our view that the ECB will not be able to raise rates before the second half of 2011.

Spain: additional expenditure cuts make more credible the deficit target of 3% of GDP by 2013

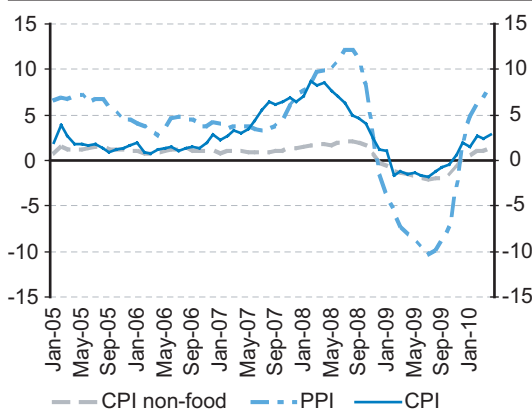
An additional expenditure cut was announced by Spanish Government which accelerates fiscal consolidation. Government estimates suggest that the plan will reduce the public deficit in 2010 and 2011 by an extra 0.5% of GDP and 1%, respectively, to 9.3% in 2010 and to 6% in 2011. The most important expenditure cuts concern Central Government public investment and public civil service wages (both by €6 bn, 0.6% of GDP each). Expenditure cuts also affect pensions (frozen as of 2011), the benefits per child born (cancelled from 2011), international aid (0.06% of GDP) and State and Local Governments expenditure cuts (0.12% of GDP). These measures are very positive, showing the government's determination to implement strong actions, which make the deficit target of 3% of GDP more credible by 2013. However, this important step in the right direction should be soon complemented with necessary structural reforms.

China: overheating risks increasing, but still manageable

April data show the Chinese economy continued to expand at a steady pace, with overheating risks rising somewhat. CPI inflation (+2.8% y/y in April, the fastest pace in 18 months), housing prices (+12.8%) and bank credit (+22% y/y) were above market expectations. However, core inflation (excluding food and energy) remained subdued, registering 0.7% y/y. Moreover, the growth of industrial production, at 17.8%, slowed from the previous month (18.1% y/y). Additional measures to cool the economy are likely in the coming months. In particular, we expect additional quantitative measures to restrain credit growth and liquidity, supported by small interest rate hikes in 2Q10 and 3Q10. We expect gradual currency appreciation to commence in 2Q10, resulting in an appreciation of around 4-5% for the RMB against the USD by end-2010 (RMB6.54 per USD). The timing of interest rate hikes and currency appreciation could be delayed, depending on the authorities' assessment of spillovers from developments in Europe. We forecast CPI inflation of 3.1% by end 2010, as tightening measures take effect.

Chart 4

China: CPI and PPI inflation (y/y % chg.)



Source: BBVA-ERD

Chart 5

ECB deposit facility vs. swap Eonia (1-Month)



Source: Datastream

Calendar: Indicators

US: CPI (Headline, Core) (April, Wednesday 19th)

Forecast: 0.1%, 0.1%

Consensus: 0.1%, 0.1%

Previous: 0.1%, 0.0%

Energy prices will not have a significant impact on headline inflation while core inflationary pressures will be limited. First quarter productivity and cost data showed that producers are not having pressure to increase prices. This, combined with ongoing economic slack and low capacity utilization, will keep core inflation low. In fact, recent months surprises have been tilted to the downside, thus giving the FOMC further room to hold interest rates low for an extended period as reflected in the implicit official rate in Fed fund futures.

US: Housing Starts (April, Tuesday 18th)

Forecast: 643K

Consensus: 650K

Previous: 650K

Housing starts are expected to grow for the fourth consecutive month. With demand firming, prices stabilizing and inventories of new homes at historically low levels, builders' confidence has risen to the highest level since November 2009. Nevertheless, residential construction is expected to recover at a slow pace throughout 2010. Since housing starts have a powerful ripple effect, a positive surprise in this indicator would filter through to durable goods consumption, industrial production and corporate profits.

Euro zone: PMI (Comp, Manuf, Serv) (Flash May, Friday 21st)

Forecasts: 56.8; 57.2; 55.4

Consensus: 56.6; 57.1; 55.4

Previous: 57.3; 57.6; 55.6

PMIs reached their highest levels recorded before the crisis and are in the expansionary territory since the beginning of the year. In May, they are expected to decline slightly because the possible negative effect of the sovereign debt crisis on agents' confidence. However, the relative calm after EC and ECB strong measures and after further fiscal measures adopted by some governments to cut public deficit, put some upside pressures to our forecasts if respondents have answered after measures have been taken.

Euro zone: Trade Balance (March, Tuesday 18th)

Forecasts: €2.8bn

Consensus:

Previous: €3.3bn

The trade balance in the euro zone is expected to narrow slightly in March, but to remain relatively stable, as observed in recent months. In particular, while exports are expected to continue to increase driven by the depreciation of the euro and the improvement of international trade, imports are also expected to increase again pushed for the purchase of inputs used in the recovered industrial sector, and in line with German figures of external trade released last week.

Mexico: Monetary Policy Decision (Friday 21st)

Banxico will keep the overnight rate unchanged at 4.5%. The statement accompanying Banxico's rate decision will hint that i) it is in no hurry to increase the reference rate –given how closely inflation is following the expected path–; and ii) that the narrowing of the output gap is the key development to watch, and will prompt the withdrawal of the monetary stimulus.

Taiwan: Real GDP (Q1 y/y, Thursday 18th)

Forecast: 11.54%

Consensus: 10.3%

Previous: 9.22%

Taiwan's 1Q10 GDP growth will be of interest for assessing the strength and sustainability of the economic rebound. 4Q09 GDP came in much stronger than expected, thanks to robust external and domestic demand. Strong recent indicators point to another quarter of rapid growth. A higher-than-expected outturn, however, could reinforce market concerns of overheating in Asia. Nevertheless, we do not expect Taiwan to raise interest rates this year given still-low inflation and relatively high unemployment.

Table 1

Market movements

Interest rates	Close	Weekly change (bp)	Monthly change (bp)	Year to date (bp)	Annual change (bp)
US					
Official rate	0.25	0	0	0	0
3-month Libor rate	0.45	2	14	19	-38
12-month Libor rate	1.11	-2	16	12	-55
2-yr yield	0.79	-2	-22	-35	-6
5-yr yield	2.20	4	-35	-48	20
10-yr yield	3.49	7	-34	-34	36
EMU					
Official rate	1.00	0	0	0	0
3-month Euribor rate	0.68	0	4	-2	-57
12-month Euribor rate	1.24	-1	2	-1	-37
2-yr yield	0.55	2	-39	-78	-71
5-yr yield	1.66	1	-52	-77	-77
10-yr yield	2.87	7	-26	-52	-49
Exchange rates	Close	Weekly change (%)	Monthly change (%)	Year to date (%)	Annual change (%)
Europe*					
Dollar-Euro	1.246	-1.9	-8.2	-13.0	-7.9
Pound-Euro	0.86	-0.3	-2.2	-3.4	-3.9
Swiss Franc-Euro	1.40	-0.8	-2.3	-5.5	-7.4
New Turkish Lira- Euro	1.91	-3.5	-4.2	-10.5	-9.8
America**					
Argentina (peso-dollar)	3.89	0.0	0.5	2.4	4.4
Brazil (real-dollar)	1.78	-3.1	2.3	2.0	-14.7
Colombia (peso-dollar)	1952	-3.4	0.6	-4.5	-13.4
Chile (peso-dollar)	530	-0.3	1.9	4.5	-5.5
Mexico (peso-dollar)	12.47	-3.0	2.5	-4.7	-5.8
Peru (Nuevo sol-dollar)	2.84	-0.6	0.0	-1.8	-6.1
Venezuela (Bolívar-Dollar)	4.29	0.0	0.0	100.0	100.0
Asia**					
Japan (Yen-Dollar)	92.48	0.9	-0.7	-0.7	-2.5
China (Yuan-Dollar)	6.83	0.0	0.0	0.0	0.0
Australia (AUD-Dollar)	0.89	0.5	-4.4	-0.6	18.6
Commodities	Close	Weekly change (%)	Monthly change (%)	Year to date (%)	Annual change (%)
Brent oil (\$/b)	77.9	-0.5	-10.6	-0.1	39.1
Gold (\$/ounce)	1248.6	3.3	7.7	13.8	34.0

Continued on next page

Table 1 (cont.)

Market movements

Stock markets	Close	Weekly change (%)	Monthly change (%)	Year to date (%)	Annual change (%)
Europe					
Spain (Ibex 35)	9571	5.8	-16.9	-19.8	6.6
EMU (EuroStoxx 50)	2693	7.7	-10.6	-9.2	13.9
United Kingdom (FTSE 100)	5339	4.2	-8.3	-1.4	22.8
Turkey (Istanbul-100)	56462	7.2	-4.4	6.9	68.6
Germany (Dax)	6170	8.0	-1.9	3.6	30.2
America					
USA (S&P 500)	1157	4.2	-4.5	3.8	31.1
Argentina (Merval)	2281	5.6	-6.5	-1.7	58.5
Brazil (Bovespa)	64788	3.0	-8.1	-5.5	32.2
Colombia	12348	2.9	-1.4	6.4	37.7
Chile (IGPA)	18085	2.5	1.1	8.7	29.3
Mexico (CPI)	32342	2.7	-5.2	0.7	38.6
Peru (General Lima)	15490	4.3	-1.5	9.3	29.7
Venezuela (IBC)	61891	0.2	0.6	12.4	40.1
Asia					
Japan (Nikkei)	10463	0.9	-7.2	-0.8	12.9
China (CSI 300)	2868	1.1	-15.5	-19.8	2.6

EMBI+ sovereign spreads	Close	Weekly change (bp)	Monthly change (bp)	Year to date (bp)	Annual change (bp)
EMBI+	278	-51	47	5	-221
EMBI+ Latin America	326	-49	46	-2	-241
Argentina	696	-82	95	36	-855
Brasil	197	-43	30	5	-132
Colombia	203	-43	42	7	-140
Chile***	126	-11	17	30	-130
Mexico	155	-55	37	-9	-119
Peru	179	-38	45	14	-140
Venezuela	976	-70	170	-40	-354
Turkey	231	-54	34	34	-160

* Currencies depreciate against the euro if they experience a positive variation

** Currencies depreciate against the dollar if they experience a positive variation

*** Chile: EMBI Global

Sources: Bloomberg, Datastream and JP Morgan