Global

Weekly Watch

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Economic Analysis

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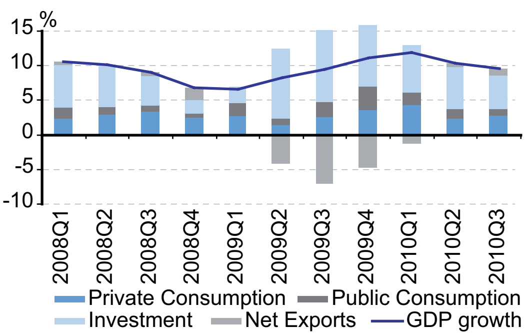
Strong growth momentum in China

China surprised markets with an interest rate increase of 25bps this week. This movement suggests that quantitative measures taken during this year have been ineffective to prevent overheating. 3Q GDP decreased to 9.6% from 10% in 2Q. However, on a quarter-on-quarter basis growth momentum remains strong (8% SAAR). Likewise domestic demand indicators, such as retail sales and urban fixed investment, showed healthy growth rates in September. Moreover, property prices and credit growth, the two segments where the Chinese government –unsuccesfully– has done more to cool down economic activity, still show signs of important strength. Strong economic data suggests that China could tighten its monetary policy further –an additional hike in 2011 is possible– but a tightening cycle is unlikely.

The BoE could soon follow the Fed

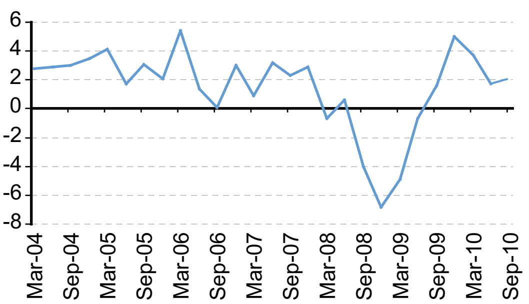
In the US, economic data is still pointing to below-trend growth. Production activity continues to look weak after the build-up in inventories during 3Q: industrial production declined in September, while the Philadelphia Fed manufacturing survey was basically unchanged in October. The housing sector will likely remain weak: housing starts were relatively stable at low levels in September while the NAHB housing market index remains at very low levels. Next week, the first advance of 3Q GDP will show a slight improvement from 2Q10, but the pace of economic growth is still not sufficient to decrease unemployment significantly, and thus, the release will likely increase the already high probability of QE2. Albeit, it remains a close call whether the BoE will soon follow the Fed, the MPC minutes show that more QE is likely: "some members" felt the likelihood of a need for further monetary stimulus had risen. Markets will focus on the release of 3Q UK GDP which could give some clues for the QE decision.

Chart 1
China's GDP Slows Year-on-year



Source: BBVA Research and Bloomberg

Chart 2
US GDP SAAR



Source: Bloomberg and BBVA Research

Highlights

Further RMB appreciation could help to prevent overheating

The recent interest rate hike is a sign that the authorities are seeking to prevent overheating, and further appreciation could help, as well as fostering the rebalancing of the economy toward greater reliance on domestic demand.

The euro's strength could indicate a possible shift in the ECB stance

We think a sustained further appreciation is unlikely. A shift in the ECB wording should be expected as a stronger euro damages Euro Area perspectives.

LatAm countries are increasing efforts to smooth the appreciation in FX

Intervention measures will likely prove to be ineffective. We think there is still some room for further appreciation.

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Markets

Statements made by central banks set the trend for interest rates

In the US, the possibility of QE2 measures by the FED is acting as a support, preventing short-term bonds from leaving the zone of historical lows in terms of IRR (around 0.36%). Long-term bonds meanwhile, have not dared to break above 2.50-2.55% (10Y Govt USA). In Europe, the trend in rates has been determined by statements made by ECB representatives (who are more reluctant to continue with unconventional policies). The rise has placed 2Y and 10Y rates in the region of 0.95% and 2.44%, respectively. The spread between the 2Y Euro and the dollar has therefore widened to around 60bps, from 44bps last week (euro rates higher), while the 10Y spread has narrowed from 12bps to 4bps (dollar rates higher).

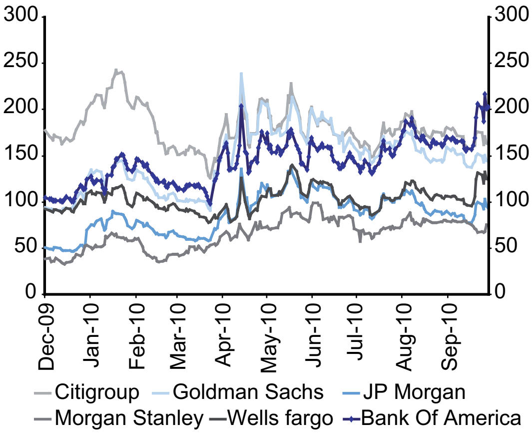
Equity: 3Q10 earnings are good, and are being priced in

Since 140 US companies have already published their 3Q10 earnings, we can already draw some conclusions, and in general they are encouraging. Sales are growing at a YoY rate of 8% (11% ex Financials), and 53% of companies have reported higher than expected sales. This is particularly noteworthy, since it is always more difficult to beat consensus sales estimates than it is to beat expected earnings. Furthermore, almost all of the positive surprises in sales have come from cyclical sectors. Earnings growth is 47.8% YoY (30.1% ex Financials) and 79.1% of companies have beaten expectations. However, perhaps the most significant aspect is that in domestic matters, US companies have put on a brave face over the cuts made, and are not talking of limited visibility. Meanwhile, the message from firms with international exposure, of which there are many, has been positive. In Europe, there is less data available, but the positive impression is the same.

Credit: US banks' CDS widen

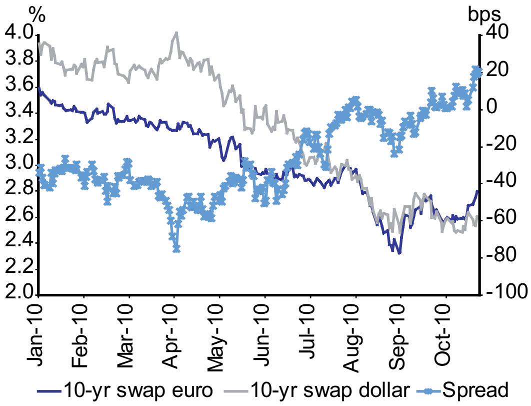
The 3Q10 results that banks have posted so far have highlighted the outperformance of retail banks vs. investment banks. Lower trading revenues are the main reason behind the poor performance. On the positive side, entities have reported lower credit losses and this provides confidence in future improvement of the underlying asset quality. That said, with regards to the rumours of possible legal costs related to US foreclosed assets, there is a new element of risk which is gaining ground. A group of US large asset managers are suing Bank of America due to irregularities in mortgages which backed securitizations sold in the past by Countrywide. Their demand is that Bank of America buy back these RMBS, which may imply sizeable losses. The CDS of US banks have widened on the back of this news: BoA widened by 21bps, Citi by 6bps; GS by 5, JPM by 9bps and Wells Fargo by 8bps despite the latter reporting better than consensus results.

Chart 3
Banks: 5-yr Senior CDS (bps)



Source: Bloomberg

Chart 4
10-yr Swaps: Euro vs Dollar and 10-yr Euro-Dollar Spread



Source: Bloomberg

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Highlights

Further RMB appreciation could help to prevent overheating

There is a broad consensus that the RMB is undervalued. Appreciation pressures are high, as reflected by the large scale of reserve accumulation. Nevertheless, the Chinese authorities have allowed relatively little appreciation in recent years, having fixed the exchange rate against the dollar for more than two years, until June 2010. Since then, the RMB has appreciated 2.7% against the dollar. Our forecast is for further gradual appreciation of the RMB going forward, by around to 4-5% for the year as a whole by end-2010. There is intense international pressure on China to accelerate the pace of appreciation. We believe that prospects for a significant acceleration are low, given the authorities preference for gradualism. Nevertheless, it is possible that some marginal speed-up in the pace may occur, perhaps as a result of discussions at the G20 meetings. The recent interest rate hike is a sign that the authorities are seeking to prevent overheating, and further appreciation could help, as well as fostering the rebalancing of the economy toward greater reliance on domestic demand. In this context, the dollar weakness will continue exerting pressure on currencies with float exchange rate regimes (both emerging and developed).

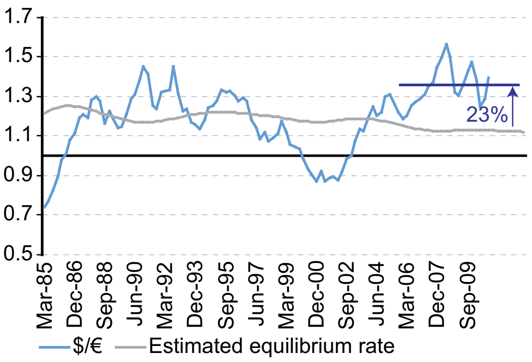
The euro's strength could indicate a possible shift in the ECB stance

Over the past month, the USD has intensified its appreciation trend against the EUR, but a sustained further appreciation is unlikely. The recent appreciation is a result of two short term factors: 1) different communication strategies between FED and ECB and 2) the speculation of short positions. The FED has been very explicit in communicating its future implementation of quantitative easing measures, while the ECB has not yet revealed the internal debate that exists in monetary policy. We consider that the ECB ought not to remain indifferent to the euro's strength because it is damaging for the Euro area growth. Going forward, we consider there are some possible triggers for a euro deppreciation: FDI benefits the US, the (relative) cyclical position and financial risk is worse for Europe than in 2008, changes in perceptions on relative monetary policy stances -as the Fed accelerates QE2, the ECB is expected to start making some wording changes (other options can be considered such as an extension of the full allotment) and eventual new doubts about the euro. Last, but not least, the cumulative appreciation of the euro over the last few years implies a prolonged misalignment, (we estimate an overvaluation by 20% on average over the last 5 years) which is damaging the perspective for the Euro Area.

LatAm countries increasing efforts to smooth the appreciation in FX

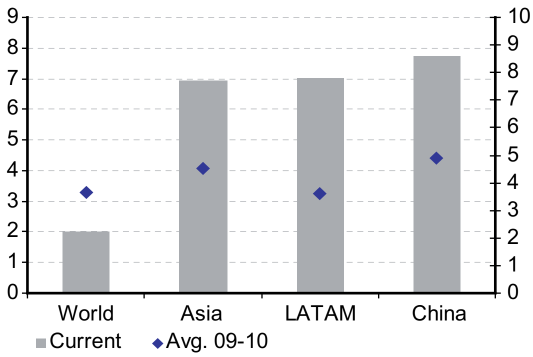
Under free-floating exchange rate regimes, most LATAM currencies are facing strong appreciation pressures as the Fed moves to a new round of easing next month. Excess liquidity is causing an important increase in flows to emerging markets; the effect on currencies is noteworthy. This pressure has led to a rise in the pace of reserve accumulation across emerging market economies. LATAM central banks are trying to offset the dollar decline. Accumulation of FX reserves in the last few months has risen appreciably relative to previous quarters and to the average pace in the past two years. Yet, these measures have not succeeded. Some countries can initially offset appreciation pressures, but additional efforts are difficult as they generate sterilization problems. In countries with deeper financial markets such as Brazil, even with other capital control measures (e.g. the increase in the IFO tax to 6%), efforts will prove ineffective. Our view is that these interventions will likely smooth the appreciation trend, but will not cause a reversion of exchange rates to previous levels. In this sense, appreciation will consolidate. Our perspective is that there is still room, albeit not much, for further appreciation considering the abundant liquidity, high returns and low risk. Nonetheless, the currencies that have appreciated the most recently (e.g. the Brazilian real) show some initial signs of misalignment and in turn, will appreciate less going forward.

Chart 5
Nominal Exchange Rate and Estimated Equilibrium Rate



Source: BBVA Research

Chart 6
Reserve Accumulation, EM (MoM % chg, 3-Month Sum; 2007-2010)



Source: Bloomberg and BBVA Research

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Calendar: Indicators

Eurozone: Flash estimate inflation (October, October 29th)

Forecast: 1.9% y/y	**Consensus:** n.a.	**Previous:** 1.8% y/y

Comment: Inflation is expected to increase timidly in October to 1.9% y/y, driven mainly by another acceleration of energy inflation, as the rise of the barrel of Brent which not be completely offset by the recent appreciation of the euro. The flash estimate does not provide information about core inflation, but we expect to remain relatively stable at around 1% y/y, although higher prices for both non-energy industrial goods and processed food could push it slightly upward to 1.1% y/y in October, while service inflation will remain stable. Both headline and core inflation are expected to remain broadly stable for the rest of the year. **Market impact:** A positive surprise could have a greater impact on markets, since recent declarations from the ECB have shown that some of its members are already thinking of an early exit strategy.

United Kingdom: GDP (Q3, October 26th)

Forecast: 0.4% q/q	**Consensus:** 0.4% q/q	**Previous:** 1.2% q/q

Comment: GDP in Q3 is expected to increase by a mere 0.4% q/q slowing down from a 1.2% q/q, well above expectations, registered in Q2. Different confidence and leading economic indicators for Q3 anticipate a slower pace of growth, however as they have been posting increases slightly above epxectations there are some up-ward risks. In any case, forecast for 2010 remains at an average growth of 1.5%. **Market impact:** If signs of economic recovery keep on showing signs of weakness and not firmly sustainable over time the current debate on the need of further QE measures will become more prominent.

US: Durable orders (September, October 27th)

Forecast: 1.2% m/m	**Consensus:** 0.8% m/m	**Previous:** -1.5%m/m

Comment: In line with our expectation, new orders for manufactured durable goods declined 1.5% (revised from -1.3%) in August. One of the main drivers of this decline was transportation equipment which dropped 10.2%, equivalent to $5.3 billion. We expect that durable goods orders will continue to increase on a YoY basis but its pace is likely to slow down. **Market impact:** The market will be waiting for the US GDP figures which will be announced on Friday. Any significant drop in durable goods orders would signal low economic activity in 3Q10.

US: GDP (Advance) (Q3, October 29th)

Forecast: 2.1% saar	**Consensus:** 2.2%saar	**Previous:** 1.7%saar

Comment: According to Bureau of Economic Analysis' (BEA) revised final estimate, the US economy grew 1.7% (annualized) in 2Q10. Recent economic indicators continue to show signs of a weakness in the pace of the recovery. Although we expect higher growth in the 3Q10 than 2Q10, the economic growth is still not sufficient to decrease unemployment significantly. Personal consumption expenditures increased 0.2% in the first two months of 3Q but recent data indicate that the housing industry could remain a drag to the economy in 2H10. **Market impact:** Markets and the Fed are both waiting for the release and any negative news will make QE2 more likely.

Mexico: IGAE, August (October, 27th)

Forecast: 0.6% m/m	**Consensus:** n.a.	**Previous:** 0.7% % m/m

Comment: Activity deceleration path during 3Q10 seems less intense than we forecasted, as recent formal employment or manufacturing production are signaling. **Market impact:** Positive surprises on activity would be welcomed considering lack of inflation pressures and surrounding uncertainties related with USA&Mexico economic tight relationship.

Korea: GDP growth (Q3, October 27th)

Forecast: 4.5% y/y	**Consensus:** 4.7% y/y	**Previous:** 7.2% y/y

Comment: As industrial production and export growth decelerate, overall economic growth momentum is expected to moderate after the strong V-shaped rebound post-Lehman. Nevertheless, strong domestic demand and robust exports to China should continue to support growth into 2011. **Market impact:** A surprise in Q3 GDP growth on the upside could add to expectations of another interest rate hike by the Bank of Korea, which recently paused on further hikes given strong capital inflows and currency appreciation pressures.

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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	-7	-65
			10-yr yield	2.56	0	1	-93
		EMU	3-month Euribor rate	1.03	4	15	30
			2-yr yield	1.00	18	30	-38
			10-yr yield	2.47	10	18	-88
Exchange Rates	(changes in %)	Europe	Dollar-Euro	1.394	-0.5	4.4	-7.3
			Pound-Euro	0.89	1.5	4.5	-3.6
			Swiss Franc-Euro	1.36	1.2	3.3	-10.3
		America	Argentina (peso-dollar)	3.96	0.1	0.1	3.6
			Brazil (real-dollar)	1.69	2.2	-1.4	-0.9
			Colombia (peso-dollar)	1819	0.6	0.3	-5.4
			Chile (peso-dollar)	488	1.7	-0.4	-8.5
			Mexico (peso-dollar)	12.37	-0.4	-2.0	-5.0
			Peru (Nuevo sol-dollar)	2.79	0.1	0.2	-2.6
		Asia	Japan (Yen-Dollar)	81.28	0.0	-3.6	-11.6
			Korea (KRW-Dollar)	1128.90	1.7	-2.1	-4.3
			Australia (AUD-Dollar)	0.981	-0.9	2.9	6.1
Comm.	(chg %)		Brent oil ($/b)	82.4	0.0	5.5	4.4
			Gold ($/ounce)	1323.1	-3.3	2.4	25.4
			Base metals	543.2	0.6	3.7	24.6
Stock Markets	(changes in %)	Euro	Ibex 35	10939	0.6	4.2	-6.8
			EuroStoxx 50	2879	1.3	5.1	-0.3
		America	USA (S&P 500)	1181	0.4	5.0	9.4
			Argentina (Merval)	2820	3.1	11.8	22.8
			Brazil (Bovespa)	69430	-3.3	0.9	6.7
			Colombia (IGBC)	15716	2.6	11.7	42.7
			Chile (IGPA)	22343	1.0	0.9	39.0
			Mexico (CPI)	34901	0.5	5.5	14.0
			Peru (General Lima)	18514	-4.0	7.6	19.7
			Venezuela (IBC)	67398	1.8	2.2	31.7
		Asia	Nikkei225	9427	-0.8	-1.5	-8.3
			HSI	23518	-1.0	6.7	4.1
Credit	(changes in bps)	Ind.	Itraxx Main	99	-3	-18	16
			Itraxx Xover	461	-8	-68	-37
		Sovereign risk	CDS Germany	32	0	-8	12
			CDS Portugal	343	-16	-54	290
			CDS Spain	201	0	-28	135
			CDS USA	38	-2	-11	---
			CDS Emerging	210	9	-26	-54
			CDS Argentina	752	24	-18	-193
			CDS Brazil	101	4	-19	-29
			CDS Colombia	103	4	-24	-57
			CDS Chile	77	2	-6	1
			CDS Mexico	111	6	-23	-47
			CDS Peru	105	4	-18	-30

Source: Bloomberg and Datastream

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