Global

Weekly Watch

Madrid, 10 December 2010

Economic Analysis

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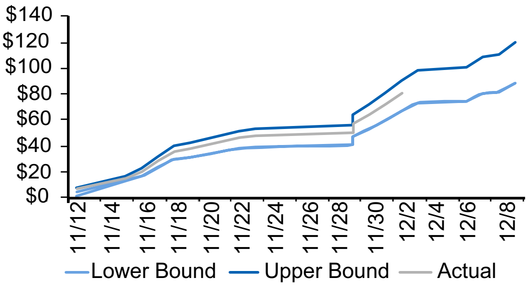
Far from a comprehensive solution

This week there were small steps forward to calm down the financial markets. The Irish 2011 budget passed the first vote in the Parliament but the final vote will take place in February. This could postpone the expected elections in Ireland, increasing the uncertainty in financial markets. In Italy the 2011 Budget Law has been approved, but political doubt remains due to the fact that the Italian Prime Minister faces a vote of confidence on the 14th of December. If Berlusconi loses, the Italian President may try to seek a new majority in the Parliament, but if he fails, there would be a call for early elections. Regarding the resolution mechanism, the Eurogroup did not reach an agreement. A proposal to increase the size of the bail-out fund has been made in the last few days by the Belgian Finance Minister, but the German Prime Minister has rejected it. Also, a proposal to launch a Euro bond was put forward by Junker and Tremonti, but again the German government was opposed to the Euro Bond on both economic (fear of higher rates) and legal grounds (reform of the European Treaty). Regarding this debate, it seems highly unlikely that there will be an agreement that establishes the right incentives and clarifies all the details on the European Mechanism by the European Council's next meeting on December 17th. Clarification is needed on such details as: 1) available amounts for financial assistance and how it will be funded, 2) Clarification of the mechanism that activates the bail out/in, 3) Specifying which parameters are susceptible to being modified during restructuring and 4) Clarification the transition period.

FED monetary meeting

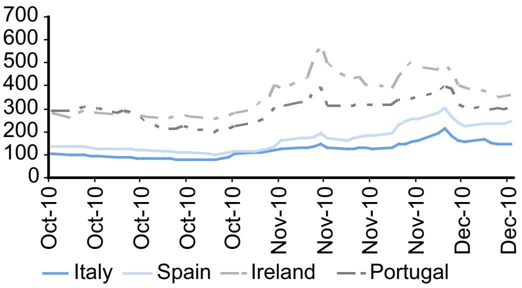
On the 14th of December, the Fed will hold its open market committee. Although it is quite unlikely that there will be changes signalling some modification to the announced QE2 amount, the market will be focused on anything in the statement that could suggest any change following the announced expansionary fiscal policy measures. We expect the FED to continue with QE2, especially after Bernanke suggested a possible increase in the amount of the QE2 a few days ago, and the FED should follow with monetary stimulus at least until unemployment is clearly on a downward trend.

Chart 1
Project and Actual Fed Purchases



Source: BBVA Research and Federal Reserve

Chart 2
2 yr Bond Spread vs German Bund



Source: BBVA Research

Highlights

Fiscal Stimulus in the US
The deal extends tax cuts, tax credits and unemployment benefits increasing fiscal deficit and debt levels.

ECB steps up bond purchases
Last week the ECB bought bonds worth 1.965 billion euros.

Expectations of more tightening in China
Following the shift from a "moderately loose" to a "prudent" monetary stance and the strong economic momentum.

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Markets

The rise in long-term rates does not change the outlook of capped rates

In recent days there has been a significant rise in yields at the long end of the dollar Govt and Swap curves, with something of a knock-on effect on euro rates. Specifically, the 10Y Govt Treasury has risen above 25bps (45bps since the start of the month), reaching levels above 3.25% (almost 3.40% in the case of the 10Y swap). There are various facets to this movement: i) the main catalyst was the announcement of the extensions to exemptions and fiscal aid in the US (in short, further fiscal stimulus); ii) this movement is not so much a reaction to expected inflation (stable at around 2.20%), but rather a rise in real rates (30bps). The combination of these two factors suggests that there may be a rise in risk premiums applied to US Govt issuance, as a result of the medium-term implications of these measures; iii) lastly, the aggressiveness of the movement is partially explained by the fact that at the end of the year trading volumes drop, which leads to exaggerated movements in underlyings. While spare capacity and unemployment rate remain very high, any additional (upside) move in interest rate could be undesirable for the Fed and prompt further action if needed.

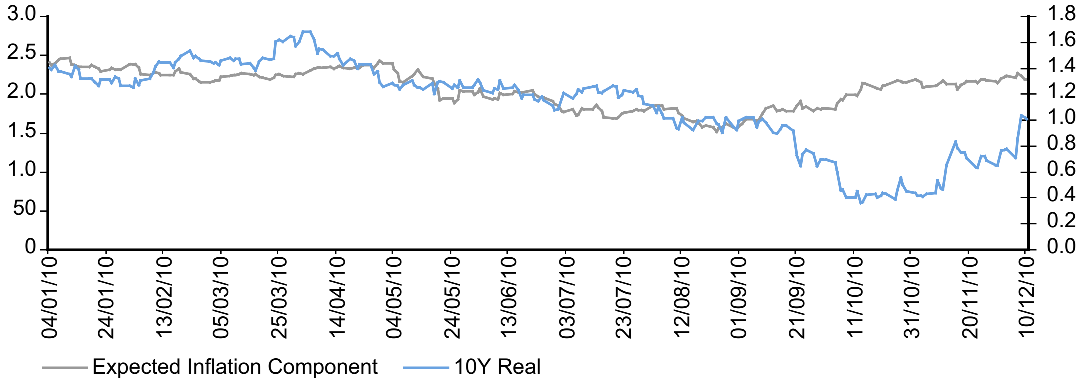
Sovereign risk remains the centre of attention on credit markets

Credit markets remain focused on sovereign risk. On Thursday the sovereign CDS of peripheral European countries widened once again. As a result, the iTraxx SovX widened 10bps to 186bps, fundamentally due to Germany's reluctance to adopt bold European initiatives to cope with the sovereign crisis. Synthetic financial indices continued to underperform corporates, especially the iTraxx Financial Subordinate, which has widened 40bps so far this week, hitting a high of 320bps on Thursday, as a result of the Bank of Ireland's announcement of a voluntary exchange of LT2 for senior GGBs at 6.75%, expiring in 2013, applying haircuts of 45-55%. For its part, the iTraxx Main moved in a narrow range over the course of the week, at around 160bps.

Equity continues to follow the footsteps of sovereigns, and is not reflecting fundamentals

In December to date the markets have recovered almost all the ground lost in November. The European sovereign risk is still the dominant driver in global markets. Nonetheless, the market fundamentals remain solid but are not reflected in share prices: world growth in 2011 is increasingly credible; profit forecasts have remained stable in the last few months in the US and Europe; the most favoured sectors continue to be those that have the most exposure to emerging markets; and valuations remain attractive: S&P 500 P/E 11e 13x and EuroStoxx 50 9.6x. Valuations in Europe are theoretically attractive, but performance will depend on the banks. If sovereign risk is contained in Europe in 2011, there will clearly be value in European stock markets. The next moment of truth will be at the summit of heads of state and government in Brussels on 16 and 17 December.

Chart 3
US 10Y Govt Rates: Real Rates vs. Inflation Component



Source: Bloomberg

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Highlights

Fiscal Stimulus in the US

The US just extended the expiring Bush tax cuts for all income brackets, as well as the Earned Income Tax Credit, the Child Tax Credit, and the American Opportunity Tax Credit. It also avoids tax rate hikes on estates and reduces the payroll tax by 2 percentage points for employees. In addition, the deal extends the unemployment insurance benefit for another 13 months and will allow businesses to write off 100% of their investment in 2011. In total, these measures add up to around $800bn or 5% of GDP. Lower tax rates and tax credits have a positive fiscal multiplier effect that will boost GDP growth in 2011-12. The impact on GDP growth could be around 0.3 to 0.9% for 2011, and 0.2 to 0.6% for 2012. However, the agreement doesn't include spending cuts and thus raises the fiscal deficit and public debt levels, dampening long-term economic growth. Therefore, while the agreement may boost short-term economic expansion, the net effect over the long-run is likely to be negative. Also, by delaying fiscal consolidation, the need for austerity measures would be greater in the future and they would be more complicated to implement.

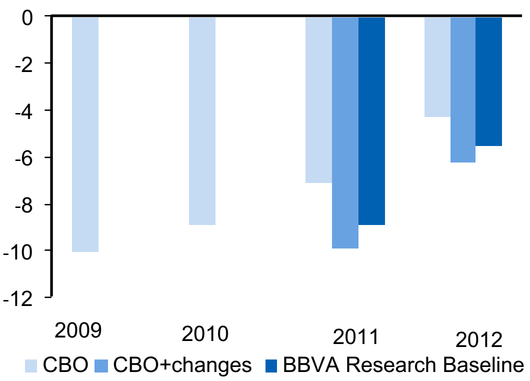
ECB steps up bond purchases

This week the ECB has intensified its bond purchases, more specifically last week it bought bonds worth 1.965 billion euros. This figure represents a clear increase with respect to last week's 1.348 bn euro bond purchase, although these numbers don't include the vast majority of the transactions which took place between the 1, 2 and 3 December, since they were still not settled. Last week's rumours regarding ECB purchases of the most vulnerable countries' bonds had already appeared weeks before. What is certain is that since the program started last May, the ECB has assigned 69 bn to bond purchases, and more than the 50% of the total amount was used during the first three weeks of the program. The bond purchases are far from reaching the amounts acquired at the beginning of the program, and the ECB is draining the liquidity it injects through the SMP program. As a result, it does not seem as though the ECB is disposed to reaching May's purchasing levels, despite the fact that there are more countries with high yields in this renewed episode of tension than in May. Furthermore, at the last ECB meeting Trichet stated that the SMP is a non-standard measure that will be interrupted when markets return to normal functioning.

Expectations of more tightening in China

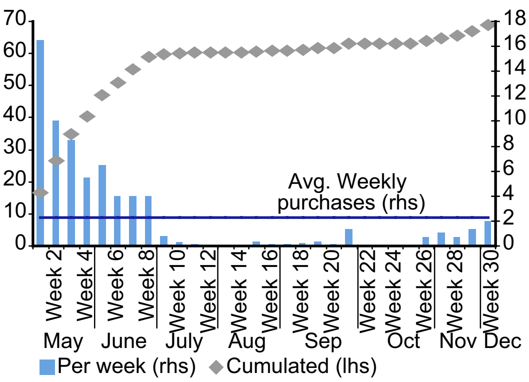
Rising inflation and strong activity and credit indicators have raised expectations of more aggressive monetary tightening in China. Following an announcement by the authorities last week of a shift from a "moderately loose" to a "prudent" monetary stance, new data show that growth momentum and credit remain strong, sparking speculation of an imminent rate hike (which would be the second, since October). M2 growth and new loans for November exceed expectations, with the RMB 7.5 trillion annual target ceiling now essentially hit, with one more month of the year to go. Inflation and other important activity indicators will be released over the weekend. We expect four rate hikes (100bp in total) between now and end-2011, in addition to further hikes in reserve requirements and today POBC has announced a hike in the required reserve ratio (RRR) by another 50bp to 19%.

Chart 4
Fiscal Deficit (% of GDP)



Source: CBO and BBVA Research

Chart 5
ECB: Sovereign Bond Purchase Program



Source: BBVA Research

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Calendar: Indicators

Eurozone: Trade balance (October, December 17th

Forecast: €2.5bn	**Consensus:** €2.5bn	**Previous:** €2.4bn

Comment: The trade surplus is likely to have widened slightly in October, as exports are expected to have maintained the momentum while imports should have grown at a higher rate, in line with signs of stronger domestic demand. Our forecasts point to a continuation of the deceleration of both exports and imports in Q4 over Q3. Looking forward, we expect the recovery in exports to weaken in coming months, but remain resilient helped by the support from the Asian economies, which could partly offset the impact of the U.S. slowdown euro. **Market Impact:** A negative surprise could have a significant market impact by raising concerns about the main driver of the recovery, i.e. the external sector.

Eurozone: Flash PMI Composite (December, December 16th)

Forecast: 55.4 points	**Consensus:** 55.5 points	**Previous:** 55.5 points

Comment: After the upside surprise in the composite PMI index in November we expect a stabilization in December. Nevertheless, the average reading for the last quarter will remain below levels printed in Q2 (56.6) and Q3 (55.7), in line with our outlook of some slowing down in Q4 but suggesting some upside risks on our quarterly GDP forecast of 0.3% q/q for Q4. The expected decline in December should be reflected both in services and manufacturing, although the latter is expected to remain more resilient. **Market Impact:** A sharp drop of PMI index could be reflecting an environment where strains in financial markets and high uncertainty about the sustainability of public finances start denting confidence in the Eurozone as a whole.

US: CPI, core (November, December 15th)

Forecast: 0.2%, 0.1% m/m	**Consensus:** 0.2%, 0.1% m/m	**Previous:** 0.2%, 0.0% m/m

Comment: U.S. consumer prices increased by 0.2% in October, slightly less than expected. The increase in headline consumer prices was mostly driven by an increase in energy prices, whereas the rise in the gasoline index accounted for almost 90% of the increase in headline prices. In October, the increases in food prices slowed down, rising just 0.1% compared to 0.3% in the previous month. In the last 12 months, consumer prices have risen 1.2%. Core inflation was flat for the third month in a row and dropped to its lowest level on a YoY basis. Core consumer prices increased only by 0.6% over the last 12 months in October. We expect deflationary pressures to remain in the short- and mid-term. **Market impact:** Flat consumer prices in November would imply that the current deflationary prices are stronger than expected and would increase anxiety about deflation.

US: Industrial Production (November, December 15th)

Forecast: 0.3% m/m	**Consensus:** 0.3% m/m	**Previous:** 0.0% m/m

Comment: Industrial production was flat in October and disappointed market participants who were expecting a 0.3% increase. Industrial production had dropped 0.1% in the previous month. Although manufacturing production has been increasing steadily in the last four months by 0.4% on average, economic activity in the utilities sector continued to decrease. In the last three days, the utilities production index declined by 2.2% on average. Therefore, while the total capacity utilization rate remained at 74.8%, capacity utilization rate in utilities declined 2.8pp to 76.6% in October. We expect a modest growth in industrial production index in November. **Market impact:** After two months of weak industrial production data, a negative industrial production would increase market volatility.

China: CPI (November, December 11st)

Forecast: 4.8% y/y	**Consensus:** 4.7% y/y	**Previous:** 4.4%y/y

Comment: Consumer price inflation is expected to have accelerated further in November on surging food prices. Inflation has become a top concern for the authorities, and government measures to stabilize food prices have had some effect, but weekly data show continued increases for food items such as sugar, vegetable oil, dairy and meat. **Market impact:** A higher-than-expected reading could increase inflationary expectations, and could significantly exacerbate worries of more aggressive monetary tightening measures.

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				Close	Weekly change	Monthly change	Annual change
Interest Rates	(changes in bps)	US	3-month Libor rate	0.30	0	2	5
			2-yr yield	0.60	14	18	-19
			10-yr yield	3.20	19	56	-35
		EMU	3-month Euribor rate	1.03	0	-2	31
			2-yr yield	1.04	18	9	-23
			10-yr yield	2.97	11	53	-24
Exchange Rates	(changes in %)	Europe	Dollar-Euro	1.326	-0.8	-2.9	-9.3
			Pound-Euro	0.84	-1.4	-1.2	-7.0
			Swiss Franc-Euro	1.30	-0.4	-2.5	-14.0
		America	Argentina (peso-dollar)	3.98	-0.1	0.3	4.6
			Brazil (real-dollar)	1.71	1.4	-0.4	-2.8
			Colombia (peso-dollar)	1907	1.3	2.6	-4.5
			Chile (peso-dollar)	476	-0.9	-0.9	-4.3
			Mexico (peso-dollar)	12.46	0.8	1.5	-2.9
			Peru (Nuevo sol-dollar)	2.82	0.1	0.8	-1.9
		Asia	Japan (Yen-Dollar)	83.57	1.0	1.3	-6.4
			Korea (KRW-Dollar)	1140.25	0.8	2.6	-2.2
			Australia (AUD-Dollar)	0.989	0.1	-0.8	8.5
Comm.	(chg %)		Brent oil ($/b)	91.4	0.0	2.9	27.1
			Gold ($/ounce)	1391.0	-1.6	-1.3	24.7
			Base metals	571.7	0.7	0.6	20.0
Stock Markets	(changes in %)	Euro	Ibex 35	10137	1.2	-0.1	-12.7
			EuroStoxx 50	2844	2.2	0.5	-0.6
		America	USA (S&P 500)	1233	0.7	1.6	11.4
			Argentina (Merval)	3369	-1.6	0.8	54.7
			Brazil (Bovespa)	67879	-2.7	-4.7	-2.0
			Colombia (IGBC)	15365	-0.1	-0.6	33.2
			Chile (IGPA)	23034	0.1	-0.7	43.6
			Mexico (CPI)	37567	0.5	3.5	17.8
			Peru (General Lima)	21808	0.7	5.9	53.8
			Venezuela (IBC)	65460	0.4	-3.3	21.5
		Asia	Nikkei225	10212	0.3	3.6	1.0
			HSI	23163	-0.7	-6.2	5.8
Credit	(changes in bps)	Ind.	Itraxx Main	106	-1	1	25
			Itraxx Xover	452	-15	-10	-35
		Sovereign risk	CDS Germany	52	6	13	29
			CDS Portugal	449	26	-30	377
			CDS Spain	325	31	47	232
			CDS USA	41	2	-1	---
			CDS Emerging	214	4	10	-69
			CDS Argentina	638	-10	4	-412
			CDS Brazil	110	5	8	-15
			CDS Colombia	111	4	9	-38
			CDS Chile	77	2	-6	1
			CDS Mexico	110	1	1	-32
			CDS Peru	114	3	-1	-13

Source: Bloomberg and Datastream

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