BBVA Research

Global
Weekly Watch

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Economics Analysis

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Some relief from global cycle data, but risks still tilted downside

After negative surprises in the US payroll data and Chinese PMI prompted markets to start pricing a double dip scenario for the global economy, it is comforting to see that investors were quick to reverse those bets on the back of this week's better tone in macroeconomic indicators. However, the balance of positive macro views and negative financial forces remains very vulnerable. First, our outlook for growth this year is below consensus in all major economies, so we still expect negative surprises on global activity to be very frequent in coming months. Second, financial risks still have to play their effect into confidence and activity fully, so risks are biased downward relative even to our forecasts.

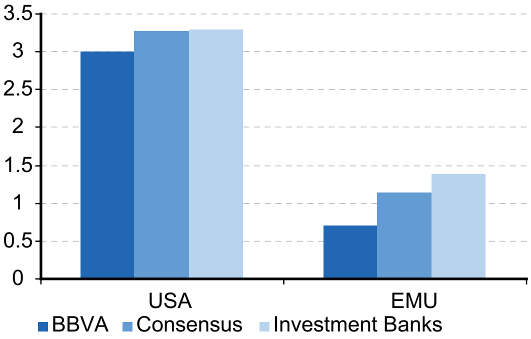
Central banks talk up the recovery

In a week with limited data releases, Bernanke's comments and the Beige book took centre stage in the US. Industrial production will corroborate positive statements with hard data. On Europe, industrial production releases were generally good. Core inflation for May next week should confirm that downward pressures on domestic prices continue.

Emerging cycle holding up

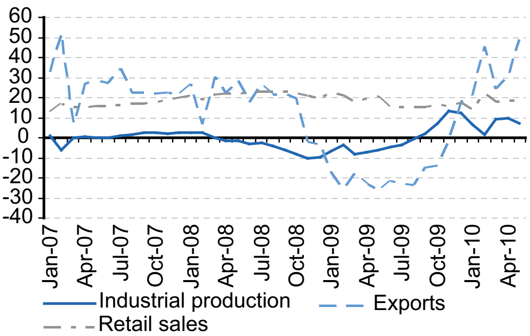
Chinese data confirmed our view that the moderation of growth is led by the authorities' efforts to control credit (which is in fact growing still slightly above targets), as exports turned out stronger than expected. Brazil's GDP data came on the strong side too.

Chart 1
USA and EMU: Forecasts



Source: Consensus Forecast and BBVA Research

Chart 2
China: Industrial production, exports and retail sales (y/y %)



Source: Datastream and BBVA Research

Highlights

USA: Fed highlights the improvement but cautiously

During multiple appearances this week the Fed chairman stated that the recovery is on track but also that some parts of the economy still remain weak. We expect, therefore, low rates for a prolonged period of time.

ECB: modest steps, limited information

The ECB is still on a gradualist path, as expected. The revision to macro projections is slightly optimistic in our view. On liquidity, extension of full allotment is positive, but lack of clarity is still a problem.

Brazil: Excessive growth continues driving interest rates up

The Monetary Policy Committee decided to raise the SELIC by 75 bps for the second consecutive time on account of an impressive GDP growth and strong inflation. We expect further rate hikes but still remain cautious.

Markets Analysis

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Markets

Sovereign bond auctions provide a breather

Despite the uncertainty prevailing in the market, several factors have brought some calm to the markets. The confidence of the FED's Chairman in the cyclical recovery of the US curtailed the probability of a double-dip scenario and allowed us to see a certain easing-off of skews among European exporters. This trend speeded up after the sound growth of Chinese exports unveiled in May. But sovereign and financial risk premiums have eased mostly due to the warm welcome of Spanish bond auctions (bid to cover ratio of 2.11) and of European debt auctions in general. The iTraxx Senior and Subordinated Financial index spreads narrowed by 22 bp and 32.7 bp, respectively from this week's highs. Despite the short-term relief, we think that the market volatility will remain high ahead of the major June futures maturities.

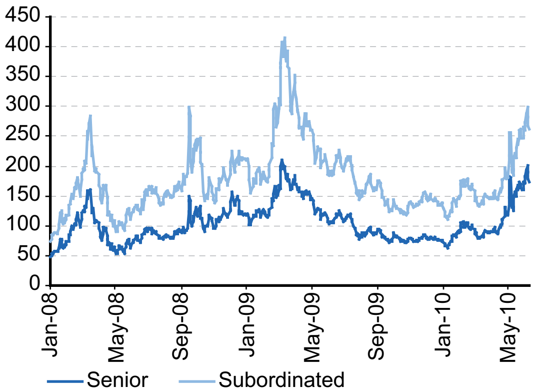
Still a long way to go

Spain and Portugal's sovereign debt auctions have been relatively well received by the market (especially taking into account the widening of their spreads vs. the German bund during the last few weeks). In the Spanish 3Y bond auction, although the final rate of the EUR3.9bn was higher than in the last auction (3.31%), the bid-to-cover ratio improved significantly (2.11 from 1.79). Portugal also obtained fairly reasonable results in its auction of 3Y and 10Y bonds (totaling 1.5bn). However, the stress phase cannot be considered over. Next week, attention should be drawn to the placement of 10Y and 30Y bonds, which could entail more difficulties (due to their longer duration). The tightening of sovereign spreads remains a possibility, though any such narrowing would be limited at least in the short term.

Credit markets remain closed

Several small-scale issues tapped the market during the last few days: National Express, with GBP225mn of 10Y bonds at G+310 bps, Caterpillar with EUR300mn at ms+85 bps and some financial names such as Rabobank, with EUR1.0bn of 3Y FRN and SEB with EUR1.0bn of 5Y covered bonds. However, we have not yet seen any relevant, large-scale issue which could be used as a benchmark to gauge investors' appetite, premiums on the secondary market or the spread vs. CDS. In our view, given that primary markets have been closed for the last six to seven weeks (which is a cause of concern for small and medium-sized financial entities), new investors will try to place their bonds on the market next week if market volatility eventually eases off. The reopening of credit markets is one of the most important signs that we are expecting to see to have a more positive market recommendation.

Chart 3
iTraxx senior vs. subordinated financial



Source: Bloomberg

Chart 4
Spain vs. Germany: 10Y govt spread

Source: Datastream

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Highlights

USA: Fed highlights the improvement but cautiously

Bernanke stated that the recovery is on track during multiple appearances this week. The Fed forecasts that GDP will grow 3.5% in 2010 and, "at a somewhat faster pace next year." While acknowledged that the labor market is improving, Bernanke said that the pace of growth will result in a slow reduction in unemployment while inflation will keep subdued. One of his most positive remarks was that, "the incoming data suggest that gains in private final demand will sustain the recovery in economic activity," but residential and commercial real estate and state financial situations could restrain the pace of recovery. While Bernanke did not specifically address the timing of interest rate hikes, his scenario of moderate economic growth, high unemployment and subdued inflation are in line with our expectation that the Fed will hold rates low for a prolonged period of time.

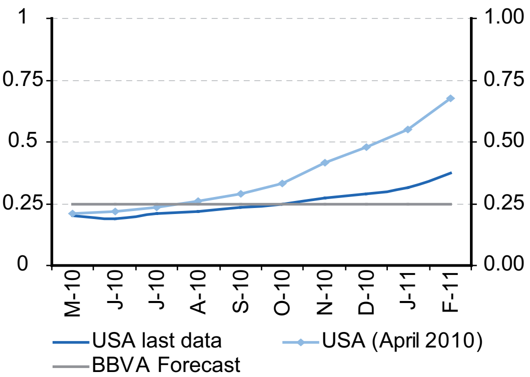
ECB: modest steps, limited information

In a very important meeting, the ECB chose to play it safe and took only modest steps on the liquidity and macroeconomic front. The upward revision to GDP figures seems slightly optimistic and its probably putting too much weight on 2Q data. In inflation, the upward revision reflects the compensating impact of commodities and the Euro, but the ECB still sees (as we do) very weak domestic prices. The ECB finally did extend full allotment in 3 month LTRO until September (i.e. maturing after the planned end of weekly full allotment auctions), which is positive. Mr. Trichet gave almost no indication about the likely evolution of bond purchases, which is limiting their potential benefits. All in all, the ECB is clearly still trying to be as gradual as possible. Given the exceptional circumstances involved, we feel this gradualism carries important risks.

Brazil: Excessive growth continues driving interest rates up

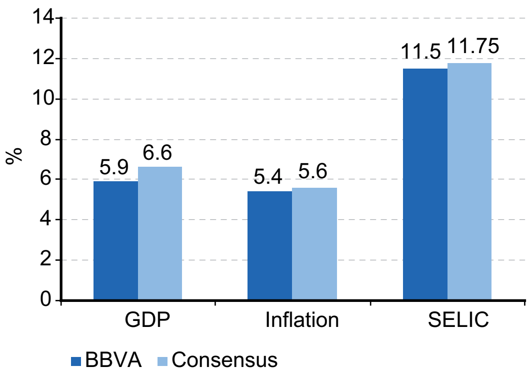
Brazil's GDP expanded at an impressive pace in the first quarter (9.0%y/y;2.7%q/q), driven by private consumption and, especially, by investments. Although there are already some signs of moderation in the second quarter, inflation continues strong and over the target (5.2%y/y in May). The Monetary Policy Committee (COPOM) decided, therefore, to raise reference interest rates (SELIC) by 75 bps to 10.25%. This highly anticipated decision follows a 75bps adjustment in April. The accumulated adjustment in this cycle, therefore, amounts to 150 bps up to now. For the next meeting in July we expect the monetary authority to adjust rates once more by 75 bps. Our call for the SELIC is, however, slightly below market consensus as by the end of the year we expect rates to be at 11.5%. New increases in reserve requirements should not be seen as a surprise, especially if domestic demand proves to be more resilient than anticipated.

Chart 5
United States: implicit official rate in Fed Funds futures



Source: Bloomberg and BBVA Research

Chart 6
Brazil: Forecasts* (end of 2010)



* BBVA's forecast for GDP are under revision
Source: BBVA Research and Central Bank of Brazil

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Calendar: Indicators

USA: Consumer Price Index (May, June 17th)

Forecast: 0.0%, 0.1% **Consensus: -0.2%, 0.1%** **Previous: -0.1%, 0.0%**

Commentary: Inflationary pressures are forecasted to remain subdued in May. Headline inflation is not expected to experience significant pressure from energy prices, while shelter prices and relatively weak demand will keep core inflation in check. **Market impact:** A negative surprise in the CPI data would further substantiate the Fed's expectation of subdued inflation in 2010 and low rates for a prolonged period.

USA: Industrial Production (May, June 16th)

Forecasts: 0.6% **Consensus: 0.8%** **Previous: 0.8%**

Commentary: May's strong growth in the manufacturing industry, as illustrated by the ISM Manufacturing Index, is expected to translate into a significant improvement in industrial production (IP). **Market impact:** A positive surprise in Wednesday's data would be a signal to markets that business investment is picking up and that private demand is firming outside of fiscal stimulus.

Euro area: Inflation (May, June 16th)

Forecasts: 1.6% y/y **Consensus: 1.6% y/y** **Previous: 1.5% y/y**

Commentary: The second estimate will provide the details on the evolution of core inflation, for which we expect to remain stable at 0.7% y/y, after falling by 0.2pp in April from 0.9% y/y in the previous month. Looking forward, core inflation should fluctuate at around 0.7% y/y in coming months. **Market impact:** Worries are tilted towards lower core inflation, so continued fall would sparkle fears of the eurozone approaching a a deflationary territory.

Euro area: Industrial production (April, June 14th)

Forecast: 0.7 m/m **Consensus: 0.6% m/m** **Previous: 1.5% m/m**

Commentary: After the mixed results in April where both French and German IPI's surprised downwards - Germany with a lower than expected growth of 0.9% m/m (13.3%) and France with a decline of 0.3% m/m (7.9%) - while Italy's grew by 1% m/m (7.8% y/y), well above expectations, we expect an increase of 0.7% m/m for the whole euro area. **Market impact:** Given the backward looking nature of this indicator and the already settled feeling of recovery in economic activity we do not expect major reactions.

Mexico: Monetary policy decision (June 18th)

Forecast: 4.5% **Consensus: 4.5%** **Previous: 4.5%**

Commentary: Banxico will keep the monetary rate at 4.5%. Since the previous monetary meeting one month ago, the balance of risks of inflation has moved down as a result of deep price falls in May CPI, second in a row downwards surprise. **Market impact:** There is no foreseeable probability of Banxico changing its monetary stance if considering the current wording, analyst's surveys or recent moves in financial markets.

India: Wholesale Price Index for May (June 14th)

Forecast: 9.58 **Consensus: 9.60** **Previous: 9.59**

Commentary: While probably having peaked, we expect WPI inflation to remain high in May on account of rising food and electricity prices. The authorities have so far responded through two 25bp interest rate hikes and increases in the required reserve ratios. We expect inflation to moderate to 8.5% by the end of the calendar year as the harvest season leads to lower food prices. **Market impact:** A higher than expected WPI outturn, together with recent robust GDP growth (8.6% y/y in January-March) could raise expectations of further rate hikes at or before the RBI's next policy meeting on July 27.

Table 1
Market data

			Close	Weekly change	Monthly change	Annual change
Interest rates (changes in bps)	US	3-month Libor rate	0.54	0	10	-9
		2-yr yield	0.74	2	-8	-52
		10-yr yield	3.25	5	-28	-54
	EMU	3-month Euribor rate	0.72	1	4	-55
		2-yr yield	0.47	-1	-14	-122
		10-yr yield	2.57	-1	-37	-106
Exchange rates (changes in %)	Europe	Dollar-Euro	1.208	0.5	-4.0	-13.9
		Pound-Euro	0.83	0.3	-3.0	-2.2
		Swiss Franc-Euro	1.39	-0.4	-0.8	-8.0
	America	Argentina (peso-dollar)	3.92	-0.1	0.6	4.1
		Brazil (real-dollar)	1.81	-2.0	2.1	-5.6
		Colombia (peso-dollar)	1926	-2.0	-1.7	-4.5
		Chile (peso-dollar)	538	-0.3	1.5	-4.3
		Mexico (peso-dollar)	12.69	-1.6	2.7	-5.4
		Peru (Nuevo sol-dollar)	2.84	-0.1	0.3	-4.4
	Asia	Japan (Yen-Dollar)	91.62	-0.2	-1.3	-6.8
		Korea (KRW-Dollar)	1247.35	1.9	10.3	-0.7
		Australia (AUD-Dollar)	0.848	2.6	-5.7	4.3
Comm. (chg %)		Brent oil ($/b)	74.8	3.7	-6.7	5.4
		Gold ($/ounce)	1226.9	0.6	-0.5	30.6
		Base metals	473.7	0.9	-3.7	16.1
Stock markets (changes in %)	Euro	Ibex 35	9559	7.1	-4.2	-1.6
		EuroStoxx 50	2642	3.4	-4.4	5.3
	America	USA (S&P 500)	1082	1.6	-6.5	14.4
		Argentina (Merval)	2260	3.6	-0.9	36.6
		Brazil (Bovespa)	62964	2.1	-2.8	17.6
		Colombia (IGBC)	12301	0.6	-0.4	27.2
		Chile (IGPA)	18374	1.8	1.6	18.9
		Mexico (CPI)	32149	3.7	-0.6	26.3
		Peru (General Lima)	14197	2.7	-8.3	2.6
		Venezuela (IBC)	64321	1.6	3.9	48.3
	Asia	Nikkei225	9705	-2.0	-8.6	-4.2
		HSI	19872	0.5	-2.7	5.2
Credit (changes in bps)	Ind.	Itraxx Main	133	6	35	26
		Itraxx Xover	604	14	142	-76
	Sovereign risk	CDS Germany	39	-10	-6	4
		CDS Portugal	290	-62	91	213
		CDS Spain	206	-51	54	110
		CDS USA	38	-3	0	---
		CDS Emerging	286	-8	49	-91
		CDS Argentina	1110	-62	214	-754
		CDS Brazil	141	-5	20	-28
		CDS Colombia	162	-7	17	-45
		CDS Chile	103	-2	15	-21
		CDS Mexico	139	-6	20	-69
		CDS Peru	139	-7	20	-43

Sources: Bloomberg, Datastream and JP Morgan

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