BBVA Research

Global

Weekly Watch

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Economics Analysis

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The Euro "under review"

Reading the impact of Europe on markets is becoming increasingly difficult. Pessimists argue (correctly) that market reaction to rumors on China's reserve management and contagion to financial systems is evidence of a highly unstable situation. Optimists can comfort (correctly, too) from the fact that critical levels were not breached and that markets were able to recover after official reassurance. It all seems to depend on policy decisions right now and implementation is the key to success or failure.

The cycle still supportive, but beware of initial confidence impacts

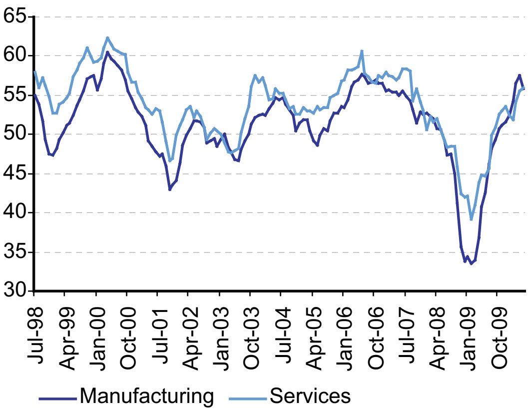
In the US, data on claims suggests the labor market remains the weakest link on a increasingly convincing recovery. Next Friday's labor report will be, as usual, highly relevant and we are moderately optimistic (even if still below consensus). In Europe, PMIs came in line but some of the improvement in household optimism of late 2009 is fading, and that is something to watch carefully. Inflation for the Euro area next week should increase slightly, but a negative surprise there could also be damaging to markets.

Emerging markets confirm softer stance on tightening

Asian and Latin America activity data were strong during the week. Markets are increasingly comfortable with the idea that the Chinese authorities will delay any movement (particularly after Geithner's visit). We expect a moderation, but if China's PMI surprises on the upside this comfort may prove short-lived.

Chart 1

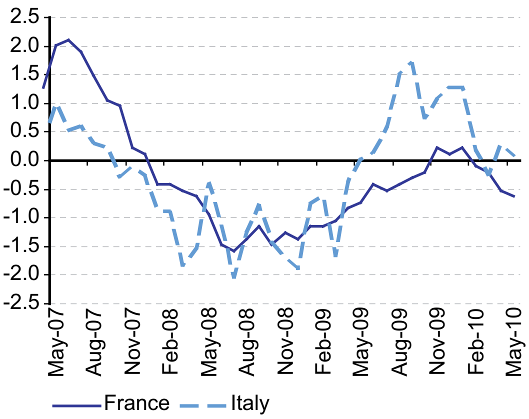
Euro Area: PMI survey



Source: NTC Economics Ltd

Chart 2

Household Confidence (normalized series)



Source: NTC Economics Ltd

Highlights

US Financial Reform Reaches Conference Committee

By July, we expect a relatively moderate reform. In particular, limited impact on swaps desks, no prohibition of non-traditional activities (but higher costs) and no substantive harm of consumer credit reform.

How to get there? UK, Italy and Germany release initial fiscal details

The path of fiscal tightening is progressively clearer across Europe. The UK, Italy and Germany released additional details of their austerity plans. Italy is focusing on expenditure cuts, and overall.

How could the European crisis alter the Brazilian monetary cycle?

Our call for BACEN is below consensus on account of European risks and of our more optimistic view on inflation. If the former continue, inflation would moderate faster, making likely a softer approach by BACEN.

Markets Analysis

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If there is to be a sustained market recovery, the credit market must open and the interbank market must stabilize…

Markets will continue to pay close attention to the performance of the interbank market and the speeding up of the consolidation in the Spanish banking sector. The market has responded positively to newsflow from China, rebutting a review of euro-denominated assets. This supported the euro and fuelled the equity rally. In our view, the opening of the credit market would be one of the positive signs that would mark an end to this correction in equities, together with more stable debt markets.

…but at present there are still no signs of activity on the primary credit market…

Credit market spreads are still very tight, with sovereign CDS trading wider than corporate debt CDS (SovX 142 bps vs. iTraxx Main 118 bps). Financials are also wider than non-financials (iTraxx Fin Senior 163 bps. vs. iTraxx No-Fin 105 bps).

In the short term, we are unlikely to see a major change of trend mostly because primary markets are still closed and there is still plenty of funding that the public sector and financials need to get done this year. The plans approved by European countries to cuts their deficits have failed to ease market uncertainties; in fact, many investors are concerned about the impact of government expenditure cuts in 2011.

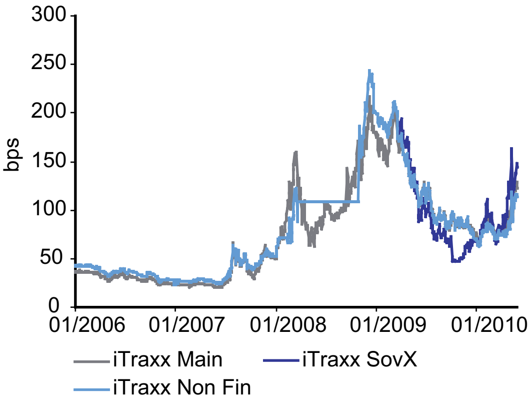
In sum, we think that markets' concerns are overstated, as we believe the EU strategy (strong support, plus strong fiscal adjustment) offers a solid pillar for the medium term. In the recent crisis, purchase programmes from central banks, e.g. the TARP by the Fed, the APS by the BoE or the covered bond scheme by the ECB have been very successful in order to open primary markets and to provide a major floor to valuations. Therefore, we are constructive in the medium and long term for credit markets but keeping a neutral stance in the near term.

…and although there is some degree of stabilization in debt rates, market uncertainty still reigns

The 17 bps rise in the dollar 10Y government and the rise of 13 bps in Europe suggest that the aggressive flows into safe-haven assets could be easing somewhat, pointing to a bullish movement in yields in the short term, with targets in the region of 3.50% for the 10Y Govt USA and 2.85/2.90% for the 10Y Govt Eur (still below 3%, the breach of which coincided with the current risk perception phase on markets).

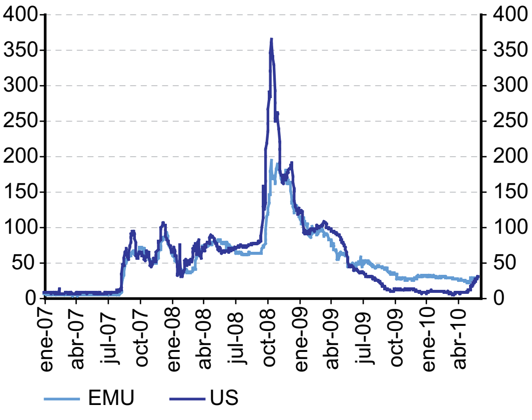
One element which is sustaining scepticism is the tightening in the bank funding market, especially as regards access to funding by European banks. LIBOR 3M rates remain particularly high (above 0.50% in dollars and 0.70% in euros) and have hardly shown any positive sign of contagion from the improvement in other markets. No substantial improvement in asset-swaps either, especially in the Eurozone and in short terms (still around 80bps for 2Y yields). A correction in this regard would be key to a substantial, consolidated improvement in the perception of banking risk and also of global risk.

Chart 3
European Synthetic Indices



Source: Bloomberg

Chart 4
Interbank markets: 3 month rates Spread (3M LIBOR -3M OIS)



Source: Bloomberg & BBVA Research

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Highlights

US Financial Reform Reaches Conference Committee

After the successful passage of the Senate's version of financial regulation last week, members from both wings of Congress must now meet to decide on a final version of the bill to be passed and eventually signed into law. Although the House and Senate versions of financial reform are mostly similar, the remaining details are doggedly contested. The main issues in contention revolve around the Volcker Rule, derivatives and consumer protection. A binding constraint on the discussions will be the tenuous balance of 60 votes required in the Senate and moderate Senate Republicans will find themselves extremely popular over the next few weeks. Both televised and closed-door meetings will occur throughout the month of June and eventual signing by the President in July. Our expectation is for standardized derivatives to shift to central clearinghouses, but without a forced spin-off of swaps desks. We also expect higher capital and liquidity requirements for nontraditional banking activities rather than outright bans. In our view, consumer financial protection as described in the House version of the financial reform will not substantively harm the financial industry.

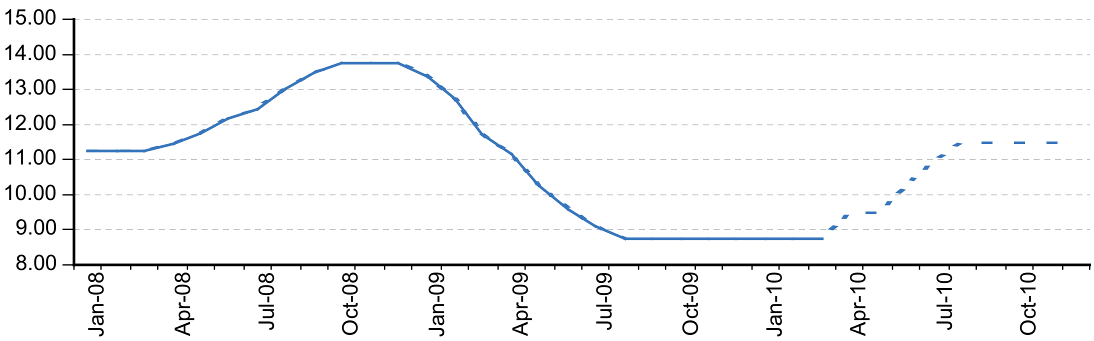
How to get there? UK, Italy and Germany release initial fiscal details

During the week, we got some details of how European nations plan to get their deficits on track. UK Chancellor Osborne provided the details of the 6bn GBP savings for this fiscal year, mainly based on expenditure reductions, to be complemented by more drastic measures to attain a target deficit of 160 bn GBP for this year. In Italy, austerity measures are more defined: the reduction in the deficit will be around 24 bn EUR (1.5% of GDP) equally distributed between 2011 and 2012, with measures tilted towards expenditure. This announcement does not seem to change the pace of consolidation already announced in the SGP last January. Germany also joined the wave of announcements of austerity policies this week with the intention of becoming an example to the rest of euro area members. The target is to reduce the deficit by half in four years. Details are expected by the end of June, and the task will be complicated by the unexpected fall in tax collections.

How could the European crisis alter the Brazilian monetary cycle?

Given the dynamism of activity and the surge in inflation, the Central Bank was forced to adjust interest rates up by 75bps to 9.5% in April. This adjustment is expected to continue in the next meeting, where we see an increase of 75bp. From then on, we expect only 125bp additional tightening in the reminder of the year, below consensus, because the economic growth and inflation is expected to moderate and because of increasing financial risks related to Europe. Although the depreciation of the Real could help to drive inflation up, the direct impact of lower commodity prices on domestic prices is expected to predominate over the pass-through effect. Because of this, if European woes continue, inflation in Brazil is likely to move downwards faster, which could moderate the monetary cycle even below our current forecast.

Chart 5
Interest Rates - SELIC (yearly rate)



Source: BBVA Research

Calendar: Indicators

USA: ISM Manufacturing Index (May, June 1st)

Forecast: 59.9% **Consensus: 59.5%** **Previous: 60.4%**

May's regional manufacturing indices pointed that the pace of expansion in manufacturing could slow slightly. The ISM may fall back to 59.9 from 60.4, but the level will still remain above the historical average of 52.0. A positive surprise in this index would be a good sign that business spending is firming in 2Q10 and strengthen the Fed's view of sustainability in the recovery.

USA: Non-Farm Payrolls and Unemployment Rate (May, June 4th)

Forecast: 375K, 9.9% **Consensus: 500K** **Previous: 290K, 9.9%**

The labor market is expected to gain momentum in May as job creation accelerates in the private sector and the Census adds additional temporary jobs. Nevertheless, the unemployment rate is expected to remain at 9.9% due to an influx of new labor market participants as formerly discouraged workers resume their job search. Consumers have been reacting well to the payroll data, so a positive surprise in this report could significantly boost consumer confidence and consumer spending.

Euro zone: Flash HICP (May, May 31st)

Forecasts: 1.6% y/y **Consensus: 1.7% y/y** **Previous: : 1.5% y/y**

Annual inflation rate is expected to increase slightly by 0.1pp to 1.6% y/y in June, due to higher prices of both food and energy. The flash estimate will not provide details on the evolution of core inflation, for which we expect to remain stable at 0.7% y/y, even in coming months. We estimate that there are some downside risks to our forecast as a result of the observed weakness in private consumption and the deterioration in consumers' confidence in H210 due to widespread uncertainty in financial markets and the strong fiscal adjustment.

Euro zone: Unemployment rate (April, June 1st)

Forecasts: 10.1%y/y **Consensus: 10.1% y/y** **Previous: 10.0% y/y**

In April, the unemployment rate may increase slightly to 10.1%. Looking forward, we also expect unemployment rate to deteriorate further. On the other hand, next week the detailed results of eurozone's Q1 GDP will be released. Flash data showed that GDP grew by 0.2% q/q in Q1. We estimate that this increase should be driven by public consumption and inventories, which offset the slightly decline in private consumption and the fall in investment (although at slower pace). As a result, domestic demand should contribute positively to GDP growth, while net exports contribution should be flat.

Peru: Monthly inflation (May, June 1st)

Forecast: 0.1% m/m **Consensus: 0.17% m/m** **Previous: 0.03% m/m**

May's inflation rate is expected at 0.1%, resulting from a downward correction in food prices and a cutback in regulated electricity tariffs. On a yearly basis, the inflation rate is expected at 0.9, below the inflation target settle by the Central Bank. Nonetheless, inflation expectations are progressively heading up mainly due to a faster than expected recovery in real activity and an upward swing in domestic fuel prices.

China: PMI (May, June 1st)

Forecast: 54.1 **Consensus: 53.8** **Previous: 55.7**

China's PMI is expected to slip from the previous three-month high of 55.7 in April. Both our forecast and the consensus expect a weaker reading due to the government's tightening measures to reduce the risks of overheating and the spillover effects from the European debt crisis. An upward surprise in this indicator would reinforce market concerns about further tightening measures.

Table 1
Market movements

			Close	Weekly change	Monthly change	Annual change
Interest rates (changes in bps)	US	3-month Libor rate	0.54	4	19	-12
		2-yr yield	0.83	7	-17	-9
		10-yr yield	3.32	8	-40	-14
	EMU	3-month Euribor rate	0.70	0	4	-57
		2-yr yield	0.54	2	-26	-88
		10-yr yield	2.68	2	-38	-91
Exchange rates (changes in %)	Europe	Dollar-Euro	1.240	-1.2	-6.4	-12.2
		Pound-Euro	0.85	-2.2	-1.6	-2.7
		Swiss Franc-Euro	1.43	-1.1	-0.6	-5.5
	America	Argentina (peso-dollar)	3.91	0.1	0.7	4.3
		Brazil (real-dollar)	1.81	-2.3	5.1	-7.8
		Colombia (peso-dollar)	1968	-1.3	0.0	-7.9
		Chile (peso-dollar)	531	-2.3	2.3	-5.6
		Mexico (peso-dollar)	12.81	-1.5	5.0	-2.7
		Peru (Nuevo sol-dollar)	2.85	0.1	0.1	-4.8
	Asia	Japan (Yen-Dollar)	91.21	1.5	-3.0	-4.6
		Korea (KRW-Dollar)	1194.05	-1.4	7.7	-4.8
		Australia (AUD-Dollar)	0.852	3.0	-8.2	6.5
Comm. (chg %)		Brent oil ($/b)	75.3	5.1	-13.3	14.9
		Gold ($/ounce)	1215.0	3.2	4.1	24.1
		Base metals	484.2	0.2	-5.0	24.9
Stock markets (changes in %)	Euro	Ibex 35	9439	0.3	-9.6	0.2
		EuroStoxx 50	2627	2.1	-7.1	7.2
	America	USA (S&P 500)	1103	1.4	-8.6	20.0
		Argentina (Merval)	2176	2.5	-9.1	37.1
		Brazil (Bovespa)	62092	3.0	-8.7	16.7
		Colombia (IGBC)	12108	2.0	-3.2	30.7
		Chile (IGPA)	17838	0.7	-0.8	21.5
		Mexico (CPI)	32056	4.7	-2.4	31.7
		Peru (General Lima)	14646	0.5	-8.0	9.4
		Venezuela (IBC)	61722	-0.2	0.7	43.1
	Asia	Nikkei225	9763	-0.2	-10.6	2.5
		HSI	19767	1.1	-4.9	8.8
Credit (changes in bps)	Ind.	Itraxx Main	117	-3	27	-4
		Itraxx Xover	560	-27	130	-164
	Sovereign risk	CDS Germany	42	-1	-5	2
		CDS Portugal	319	-3	15	239
		CDS Spain	235	33	59	143
		CDS USA	39	0	1	---
		CDS Emerging	274	-30	54	-111
		CDS Argentina	1221	-78	374	-1353
		CDS Brazil	135	-13	13	-56
		CDS Colombia	163	-17	20	-58
		CDS Chile	102	-8	19	-43
		CDS Mexico	132	-15	17	-87
		CDS Peru	132	-14	13	-69

Sources: Bloomberg, Datastream and JP Morgan

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