

Weekly Watch

Madrid, 5 November 2010

Economic Analysis

Financial Scenarios

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The Fed announced QE2

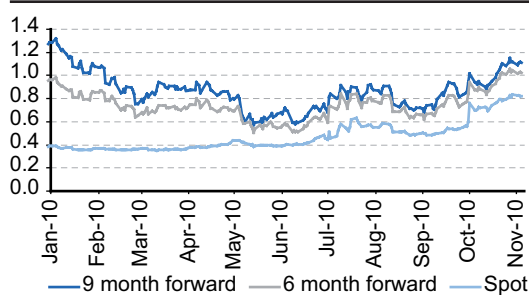
The FOMC announced the QE2, and there was no surprise in the extent or timing of it. The central bank intends to purchase \$600bn of longer-term Treasury securities by the end of 2Q11, at a pace of around \$75bn per month. Importantly, the Fed also signaled the possibility of taking more action by adjusting the pace and overall size of QE2, if needed. The Fed's commitment to buying assets through June 2011 supports our expectation of a Fed funds rate staying near zero. Despite the Fed's announcement, with the euro reaching \$1.42, and in a context of rising spreads in the periphery, the ECB meeting was rather uneventful as the monetary policy stance was left unchanged, there was less emphasis on the phasing-out of non-standard measures and a decision on liquidity was postponed until next month. However, the Fed's stance is causing further declines in the dollar, which nonetheless were partially offset after the surprisingly strong US non-farm payrolls data. In our view the impact from QE2's extent and timing – i.e. monthly purchases until the end of 2Q11 – might force the ECB to announce the extension of the full-allotment in December to a similar time horizon. Meanwhile, as expected, the BoE left rates and QE on hold, and the BoJ said that the “recovery seems to be pausing” and left the interest rate steady at zero to 0.1% as widely expected.

Tensions in the periphery are mounting

Country risk spreads in the periphery have been rising in small countries (especially Ireland; Greece and Portugal to a lesser extent). Italy and Spain have been relatively more stable. The increase in financial strain is due to the debate around possible bail-ins in Europe. Next week Eurozone Q3 GDP will be released. We expect a q/q increase of 0.5%, somewhat weaker than in the Q2. However, after better than expected economic data we are not ruling out any positive surprise in Q3 figures. Also, the market will be closely watching the local elections being held in Greece because the results could lead to the general elections being moved to an earlier date.

Chart 1

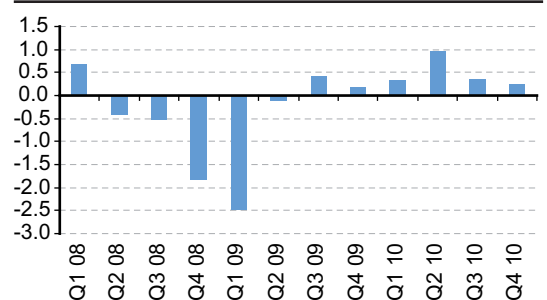
OIS 3-month Rates Implicit in OIS Swaps



Source: Datatstream and BBVA Research

Chart 2

Eurozone GDP (q/q%)



Source: BBVA Research

Markets



Highlights



Calendar



Markets Data



Highlights

Inflationary risks prompt interest rate hikes despite capital inflows

Australia and India both hiked interest rates this week by 25bps, which is a reminder that, despite concerns about capital inflows and currency appreciation, rising inflation is still foremost in the minds of policy makers.

The Anglo Irish offer will probably be accepted

Anglo Irish Bank made an offer to Lower Tier 2 bondholders to swap their dated subordinated bonds to senior debt swap with a haircut of 80%.

PMI indexes have recently picked up supported by foreign sector

Inventories could act as a bottle neck for further acceleration in activity in the US and in the Eurozone if final demand doesn't pick up.

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QE2: risk for the dollar, but support for other assets

Rates react to QE2 as expected, whilst there is still the risk of further drops in the dollar given the possibility that stimulus measures may be extended. In credit, although we do not expect as significant narrowing as that which occurred following QE1, we think that a prolonged period of low interest rates could lead to a certain flow towards more risky positions, which offer higher yields, in both corporates and financials. The market seems to be reflecting this with narrowing in synthetic credit indices, although it is still too soon to price this in.

In rates we see further room for drops in yield

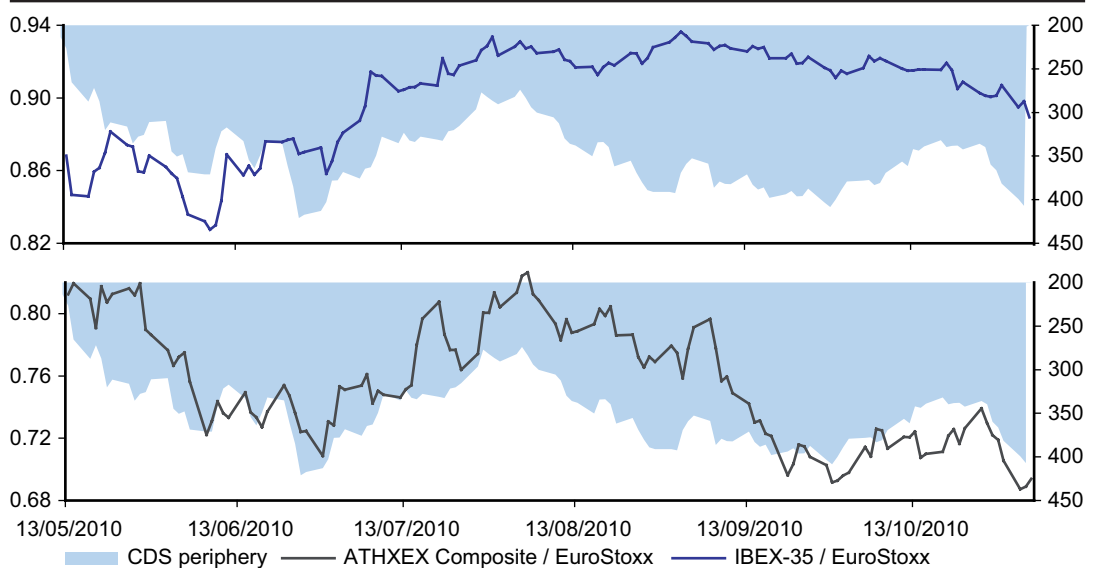
In our opinion, given that the Fed has left the door open to further action if necessary, there is still some room for Treasury rates to drop further. In addition, Treasury purchases are relatively evenly distributed across the 2Y to 10Y range, so we do not expect a major impact in terms of relative value on the curve for these terms. In any case, parallel to this directional movement is a tendency towards flattening in the 2/10Y slope. The fact that the distribution of purchases includes almost no 30Y has led to significant steepening between the 10Y and 30Y (around 20bps in just two days, to above 150bps). In our view, this relative punishment of the long end of the curve should not continue for long: firstly, the adjustment for "purchases" has already been carried out and appears to be a one-off. Secondly, in terms of direction, the 30Y does not have much more room on the upside: the current 4% level is the one the market has used to price in a scenario of low growth rates over a prolonged period.

Investors have been buying equity on the back of speculation and continue to do so following the news

Emerging equity markets, the EuroStoxx-50 and the Standard&Poors-500 are all recovering strongly and are moving slightly further away from supports, buoyed by liquidity factors (QE2 favours high yield and reasonable risk assets), improvement in macro indicators and company earnings. However, in the short term peripheral equity markets are not complying with the reasonable risk condition and cannot keep up the pace set by core and emerging markets. The marked rise in sovereign risk is responsible for this worse relative performance. This has reached the point where there is once again some correlation between periphery countries, at least in terms of equity performance, although it is clear that Greece -Ireland-Portugal are in a different league from Italy-Spain. Therefore, we think that in the short term the worse relative performance by periphery European equity markets vs. those of core European economies may continue.

Chart 3

5Y CDS Peripheral Countries* and Relative Evolution of European Stock Indices



(* CDS peripheral countries = 50% CDS Spain + 50% x [CDS (Greece+Ireland+Portugal)]/3
Source: DataStream and BBVA Research

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Inflationary risks prompt interest rate hikes despite capital inflows

Australia, India and Vietnam hiked interest rates this week by 25bps to 4.75% and 6.25% respectively in the case of Australia and Vietnam and by 100bps to 9% in India, a reminder that, despite concerns about capital inflows and currency appreciation, rising inflation is still foremost in the minds of policy makers. Indeed, as noted in our just-published Asia Economic Outlook, inflationary pressures are rising in Asia, which will make monetary authorities more alert to the need for further rate increases. However, sustained capital inflows and appreciation pressures, especially in the wake of the Fed's quantitative easing decision, may give them pause. We expect Indonesia and Thailand, which have seen large capital inflows in recent months, to stay on hold through the remainder of 2010, while Korea, which has increasing inflation pressures, is likely to hike interest rates again before the end of this year. For next year, we expect further rate hikes, at a gradual pace. We expect central banks to continue intervening to stem the pace of appreciation, while using further macro-prudential measures, and tightening of existing regulations. Some countries might introduce new measures after the forthcoming G20 meeting, following Thailand's recent increase in its withholding tax on foreign bond purchases. Korea has already signaled it is contemplating new measures.

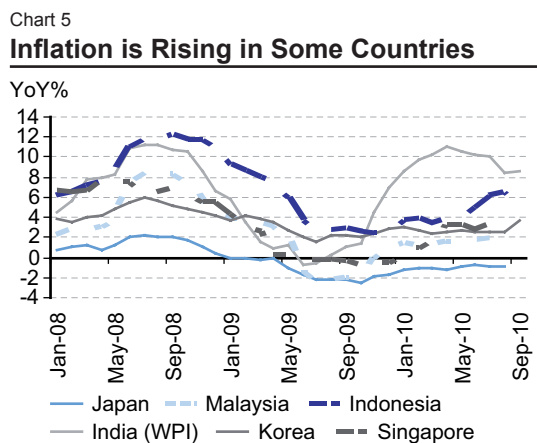
The Anglo Irish offer will probably be accepted

The latest measure taken by the Irish government to make bondholders share part of the banks bail-out costs has caused some concern on the markets as they fear other countries could follow. On the 21st of October, the Anglo Irish Bank made an offer to Lower Tier 2 bondholders to swap their dated subordinated bonds to senior debt swap with a haircut of 80%. What is different from other cases is that the bank can redeem outstanding bonds at €0.01 per €1000 and it is being proposed when the Government is considering introducing general bail-in legislation. In our opinion, the proposal will be accepted in the second meeting, as some bondholders will block the meeting and moderate the discount. Similar proposals will probably be made to subordinated bondholders of other Irish banks. However, the extension to subordinated debt in other economies is more difficult and to senior debt is almost impossible.

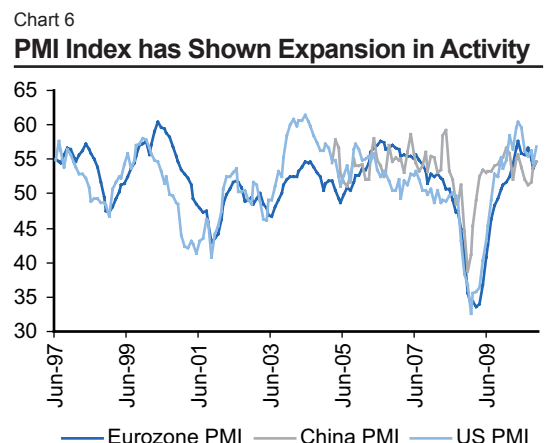
PMI indexes have recently picked up supported by foreign sector

Manufacturing Purchasing Manager's indexes are showing signs of a pick up after a downshift since last spring. In the US PMI advanced in October 2.5pp to 56.9, while PMIs in China and the Eurozone both increased 0.9pp, to 54.7 and 54.6, respectively. The best performing component out of the three manufacture indexes was the new order component, signalling that the industrial sector will keep improving in coming months. In the case of the US and the Eurozone, the increase was mainly due to the improvement in foreign demand. However the main source of concern is the high level of inventories since they could act as a bottle neck for further acceleration in activity, especially in the US and in the Eurozone as the total inventory PMI index are 9pp and 1.4pp respectively above the long term average, while in China they are still on average. That being said, customers' inventories are too low at this time, which indicates that the path towards recovery will only continue if final demand picks up. Supply prices have risen further in the three areas and stand well above the long term average, driven by the increase in commodity prices with China showing a more accelerating trend. This is a source of risk since the increase in quantitative easing policies in developed countries will push ahead commodity prices. Overall, PMI data suggest further increases in industrial activity if final demand improves.

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Source: Bloomberg and BBVA Research



Source: Bloomberg and BBVA Research

Economic Analysis

Calendar: Indicators

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Eurozone: GDP (Flash estimate Q3/2010, November 12th)

| | | |
|---------------------------|----------------------------|---------------------------|
| Forecast: 0.5% q/q | Consensus: 0.5% q/q | Previous: 1.0% q/q |
|---------------------------|----------------------------|---------------------------|

Comment: Eurozone GDP is expected to grow more moderately in Q3, by +0.5% q/q, after the strong 1% q/q of Q2. Underlying this deceleration is the lower contribution of domestic demand. In addition, lower imports (in line with weaker domestic demand) along with the dynamism of exports should be reflected in a positive contribution of net exports. Across large countries the slowdown is expected to be widespread, with Germany (around 0.6% q/q) as the main driver of the Eurozone. **Market Impact:** In our view, the risks are skewed to the upside, as very recent indicators suggest resilient activity, without clear signs of further deceleration in Q4. Higher than expected growth would impact markets expectations on future ECB policy and the euro.

Eurozone: IPI (September, November 12th)

| | | |
|---------------------------|----------------------------|---------------------------|
| Forecast: 0.2% m/m | Consensus: 0.3% m/m | Previous: 1.1% m/m |
|---------------------------|----------------------------|---------------------------|

Comment: Industrial production is expected to have increased marginally in September, after the robust growth observed in August. Industrial managers' confidence showed mixed signs once again in September: EC surveys improved further, while PMI polls declined for the second month in a row, although the latter remained clearly in expansionary territory. Overall, average industrial production in Q3 should have increased by around 1.5% over Q2, confirming the slowdown in the pace of the industrial recovery after growing by about 2.5% in previous quarters. Nevertheless, available soft data for October do not suggest a further deceleration in Q4. **Market Impact:** A very negative surprise could have a relevant market impact by raising concerns about the sustainability of the recovery, as the industrial sector has been a key driver of growth and the service sector does not seem to be taking off.

US: Wholesale Inventories (September, November 9th)

| | | |
|---------------------------|----------------------------|---------------------------|
| Forecast: 0.7% m/m | Consensus: 0.6% m/m | Previous: 0.8% m/m |
|---------------------------|----------------------------|---------------------------|

Comment: Wholesale inventories have been increasing since the beginning of 2010. Last week the Bureau of Economic Analysis announced that inventories contributed 1.44% to economic growth in 3Q10. Furthermore, the ISM inventory index increased 4.2 points to 55.6 in September which implies that wholesale inventories continued to increase in the month. We expect wholesale inventories to have jumped around 0.7% in September. **Market impact:** Weak wholesale inventories in September would point to a downward revision in 3Q10 GDP figures and increased worries about the economic recovery.

US: Trade Balance (September, November 10th)

| | | |
|--------------------------|---------------------------|--------------------------|
| Forecast: -45.0bn | Consensus: -45.0bn | Previous: -46.3bn |
|--------------------------|---------------------------|--------------------------|

Comment: The Department of Commerce estimated that in August the U.S. economy exported \$153.9bn and imported \$200.2bn worth of goods and services resulted in a deficit of \$46.3bn. In the previous month the trade was \$42.6bn and we expect the U.S. trade deficit to have declined slightly in September. **Market impact:** September international trade statistics will provide more evidence on the reliability of 3Q10 GDP estimates. A significantly smaller-than-expected trade deficit would indicate a potential upward revision in 3Q10 GDP estimates.

China: Consumer Price Index (October, November 11th)

| | | |
|---------------------------|----------------------------|---------------------------|
| Forecast: 3.7% y/y | Consensus: 4.0% y/y | Previous: 3.6% y/y |
|---------------------------|----------------------------|---------------------------|

Comment: A further rise in inflation is expected for October on ongoing food price increases. In response to rising inflation, strong activity indicators and renewed signs of property price increases, the authorities have taken further tightening measures, including an interest rate hike last month. We expect inflation to moderate to 3.2% by December. **Market impact:** A higher-than-expected CPI reading will raise expectations of further monetary tightening measures. At the same time, markets will also be watching for accompanying data on trade, PPI, investment and retail sales.

Mexico: INPC (October, November 9th)

| | | |
|---------------------------|----------------------------|---------------------------|
| Forecast: 0.6% m/m | Consensus: 0.6% m/m | Previous: 0.5% m/m |
|---------------------------|----------------------------|---------------------------|

Comment: First acceleration on consumption prices since last March to reach 4% (September: 3.7%). Non-core components such as food and base effects are behind this evolution. **Market Impact:** the consensus is in line with our own estimates, and it incorporates an end of the year with higher inflation figures. However upside surprise on prices could ease the current market euphoria on the Mexican short term curve.

Markets Data

| | | | 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 | 2 | 0 | -49 |
| | | 10-yr yield | 2.52 | -8 | 14 | -97 |
| | EMU | 3-month Euribor rate | 1.05 | 1 | 9 | 33 |
| | | 2-yr yield | 0.91 | -8 | 11 | -36 |
| | | 10-yr yield | 2.42 | -10 | 15 | -95 |
| Exchange Rates (changes in %) | Europe | Dollar-Euro | 1.411 | 1.4 | 1.6 | -4.9 |
| | | Pound-Euro | 0.87 | -0.1 | -0.8 | -2.9 |
| | | Swiss Franc-Euro | 1.35 | -1.3 | 0.5 | -10.6 |
| | America | Argentina (peso-dollar) | 3.96 | 0.1 | -0.3 | 3.7 |
| | | Brazil (real-dollar) | 1.68 | -1.0 | -0.5 | -2.2 |
| | | Colombia (peso-dollar) | 1816 | -0.9 | 1.6 | -8.5 |
| | | Chile (peso-dollar) | 478 | -2.4 | -1.3 | -8.4 |
| | | Mexico (peso-dollar) | 12.18 | -1.3 | -3.1 | -8.9 |
| | | Peru (Nuevo sol-dollar) | 2.79 | -0.2 | 0.1 | -3.7 |
| | Asia | Japan (Yen-Dollar) | 81.15 | 0.8 | -1.5 | -9.7 |
| | | Korea (KRW-Dollar) | 1108.18 | -1.4 | -1.4 | -5.0 |
| | | Australia (AUD-Dollar) | 1.017 | 3.6 | 3.7 | 11.0 |
| Comm. (chg %) | | Brent oil (\$/b) | 88.1 | 6.0 | 5.6 | 16.2 |
| | | Gold (\$/ounce) | 1398.0 | 2.8 | 4.8 | 27.7 |
| | | Base metals | 557.4 | 2.7 | 4.8 | 25.3 |
| Stock Markets (changes in %) | Euro | Ibex 35 | 10471 | -3.2 | -2.5 | -9.6 |
| | | EuroStoxx 50 | 2888 | 1.5 | 3.6 | 3.3 |
| | | USA (S&P 500) | 1227 | 3.7 | 5.9 | 14.7 |
| | America | Argentina (Merval) | 3381 | 12.4 | 28.0 | 52.1 |
| | | Brazil (Bovespa) | 72720 | 2.9 | 4.0 | 12.8 |
| | | Colombia (IGBC) | 16374 | 3.0 | 8.7 | 49.9 |
| | | Chile (IGPA) | 23079 | 0.9 | 4.8 | 45.8 |
| | | Mexico (CPI) | 36350 | 2.2 | 6.1 | 21.7 |
| | | Peru (General Lima) | 20302 | 5.6 | 7.7 | 38.8 |
| | | Venezuela (IBC) | 67626 | 0.2 | 2.0 | 33.3 |
| | Asia | Nikkei225 | 9626 | 4.6 | -0.6 | -1.7 |
| | | HSI | 24877 | 7.7 | 8.7 | 14.0 |
| Credit (changes in bps) | Ind. | Itraxx Main | 95 | -2 | -8 | 8 |
| | | Itraxx Xover | 435 | -23 | -42 | -96 |
| | Sovereign risk | CDS Germany | 36 | 1 | -3 | 15 |
| | | CDS Portugal | 437 | 59 | 34 | 377 |
| | | CDS Spain | 235 | 20 | 7 | 163 |
| | | CDS USA | 40 | 2 | -6 | --- |
| | | CDS Emerging | 184 | -20 | -18 | -95 |
| | | CDS Argentina | 602 | -23 | -118 | -461 |
| | | CDS Brazil | 91 | -9 | -13 | -41 |
| | | CDS Colombia | 92 | -8 | -12 | -65 |
| | | CDS Chile | 77 | 2 | -6 | 1 |
| | | CDS Mexico | 97 | -9 | -12 | -65 |
| | | CDS Peru | 99 | -8 | -9 | -39 |

Source: Bloomberg and Datastream

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