

# Weekly Watch

Madrid, 19 November 2010

## Economic Analysis

*Financial Scenarios*  
**Sonsoles Castillo**  
 s.castillo@grupobbva.com  
 +34 91 374 44 32

**María Martínez Álvarez**  
 maria.martinez.alvarez@grupobbva.com  
 +34 91 537 66 83

**Javier Amador**  
 javier.amadord@grupobbva.com  
 +34 91 537 3161

**Cristina Varela Donoso**  
 cvarela@grupobbva.com  
 +34 91 537 7825

**Victoria de Zuriarrain**  
 victoria.zuriarrain@grupobbva.com  
 +34 91 537 75 84

**Leanne Ryan**  
 leanne.ryan@grupobbva.com  
 +34 91 537 84 32

*US*  
**Nathaniel Karp**  
 nathaniel.karp@bbvacompass.com  
 +1 713 881 0663

## EU wants a firewall

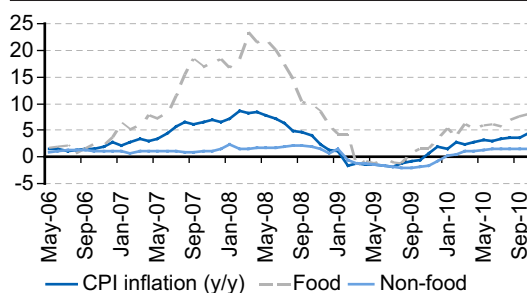
The European Union is forcing the Irish government to accept an aid package to finance its banking system. In doing so the EU is trying to act in advance in order to stop a possible contagion to other countries like Spain that could prompt an increase in the systemic risk premium. Auction results this week have shown that Spanish debt found demand. But in our view, in order for an EU aid package to act as a firewall it should be fast, covering Portugal. Moreover, indebted states should accelerate the announced reforms.

## China tightens while data backs QE2

In recent months, consumer price inflation (CPI) is diverging markedly in emerging markets (EM) and the US. Inflation pressures in EM mainly arise from rising commodity prices, while in developed countries the disinflationary effects of the weak demand are more than offsetting these effects on inflation. Monetary authorities in EM are starting to respond to the rise in inflation by gradually withdrawing monetary stimuli. After the headline annual rate of CPI rose to 4.4% in October in China, authorities announced a 50bp hike in its RRR. Meanwhile, both the Bank of Korea and the Bank of Chile, as expected, raised their reference rates by 25 bp. Next week, Banxico will hold its fondeo rate steady at 4.5%. In contrast, in the US, measures of core inflation are worryingly low. The October core CPI fell to 0.6%, the lowest on record. With the economy growing, but not fast enough to reduce high levels of unemployment, and facing disinflationary pressures, the data clearly supports QE2 and backs the Fed's case of more quantitative easing. Recent data does not suggest a change in the outlook for unemployment or inflation. In this context, and following political opposition to QE2, Fed officials defended the additional \$600bn stimulus to restore confidence that it will implement the whole amount and to ensure that it has the flexibility to increase the size if necessary. The FOMC minutes to be released next week will give markets more clues as to whether there was an ample consensus between FED members for the implemented QE2 policy.

Chart 1

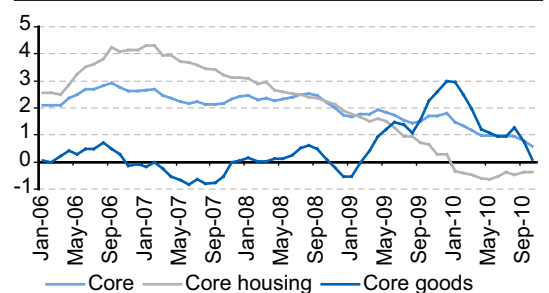
### Chinese inflation is on the rise



Source: Bloomberg and BBVA Research

Chart 2

### US: Core CPI, YoY % change



Source: Bloomberg and BBVA Research

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## Highlights

### Will China's tightening prompt a hard landing?

Given the strength of growth momentum, a supportive fiscal stance and real interest rates at low levels, we do not anticipate that tightening could affect overall growth.

### Introducing BBVA Research's new EAGLEs concept

EAGLEs (Emerging and Growth Leading Economies) seeks to identify countries whose individual contributions to world growth in the next 10 years is expected to match or exceed the average of the largest developed economies.

### Ireland closer to a rescue ...

Recent tensions in the financial markets have sparked off European sovereign debt problems again. This time the Irish and Portuguese economies are the main reason for concern. Ireland rescue seems imminent.

Markets Analysis

Markets

Macro Europe Strategy  
Chief Strategist  
**Nicolás Trillo**  
nicolas.trillo@grupobbva.com  
+34 91 537 84 95

**Ignacio González-Panizo**  
ignacio.gonzalez-panizo@grupobbva.com  
+34 91 538 63 50

Global FX  
Chief Strategist  
**Pablo Zaragoza**  
pzaragoza@grupobbva.com  
+ 34 91 374 38 64

Strategy  
**Javier Requena**  
javier.requena@grupobbva.com  
+34 91 537 83 99

Credit Europe  
Financials  
**Antonio Vilela**  
antonio.vilela@grupobbva.com  
+34 91 374 56 84

**Sovereign-financial risk and uncertainty over stricter monetary policies in Asia**

The two factors which are continuing to affect the performance of various assets are sovereign risk and the market's recent fears of more anti-inflationary measures in China. In our view, sovereign risk premiums will remain at high levels until the position on the future European rescue system is clarified for 2013 onwards (we shall have to wait until the European Council meets in December, at the earliest). With regards to China, the recent 50bps rise in the reserve ratio has only aggravated the market's concerns. However, we do not think that these measures will lead to a the cyclical dynamism being cut short in the medium term, even though they are larger than was initially expected. As a result, we see limited upside potential in the sovereign rates of core countries, and expect the euro-dollar to remain range-bound. In the case of the latter, we believe the cross will remain highly sensitive to European sovereign risk and any doubts that arise concerning the effectiveness of the US QE2 measures.

**Asian currencies more sensitive to Chinese economic cycle**

The recent bearish reaction in the region's currencies (approx. 1.5% according to the ADXY index) is significant, since it marks a break from the more supported profile they had shown until now (even during periods of increases in systemic risk in other regions). This suggests that, to some degree, the market considers these factors to be important, but we do not think there is room for greater drops in valuations.

**Cyclical sectors punished on equity markets**

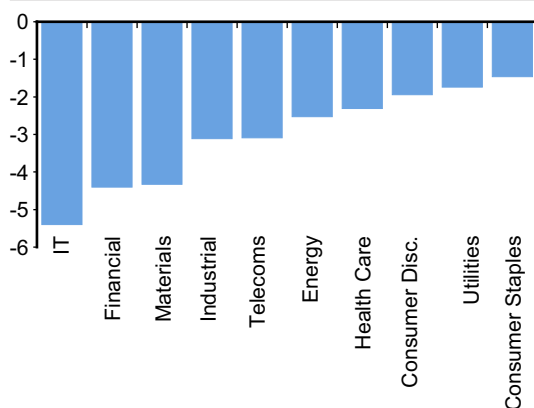
Since earnings season seems to have faded into the background, European equity markets are more affected by sovereign risk than any steps taken by China. However, the latter is having a significant impact on sector performance, which we think could last while official Asian interest rates continue to rise. The sectors which are most closely linked to the Asian economic cycle are those which have performed the worst recently, apart from the Financial sector, which is more dependent on sovereign risk – and in the short term this process looks set to continue.

**The credit market needs clarification of the situation in Europe**

News concerning a potential rescue package for Ireland have led to some easing of Synthetic indices, for both corporates (Main and XO narrowed 6bps and 13 bps respectively) and financials (Senior Financial and Subordinated narrowed 22bps and 32bps respectively), but investors are still not anticipating a convincing resolution of this problem. The clearest example is Greece, where progress in rectifying imbalances is very slow, despite its rescue package. This has led to a 73bps rise in Greek 5Y CDS, also affected by statements made by the Austrian Finance Minister, indicating that his country would withdraw its contribution to aid for Greece if the country fails to meet its deficit targets.

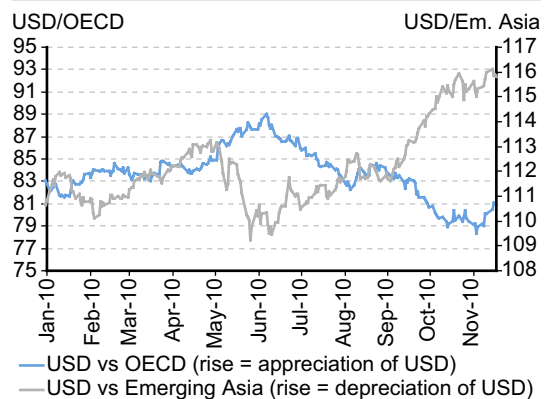
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Chart 3  
**S&P-500:  
Sector Performance During the Last Week**



Source: Bloomberg

Chart 4  
**USD Index vs. OECD USD vs  
Emerging Asian Economies**



Source: Bloomberg

Economic Analysis

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Financial Scenarios

**María Martínez Álvarez**  
maria.martinez.alvarez@grupobbva.com  
+34 91 537 66 83

Macro Europe Strategy

**Ignacio González-Panizo**  
ignacio.gonzalez-panizo@grupobbva.com  
+34 91 538 63 50

Asia

**Stephen Schwartz**  
stephen.schwartz@bbva.com.hk  
+852 2582 3218

Xia Le

xia.le@bbva.com.hk

Bingje Hu

bingje.hu@bbva.com.hk  
+852 2582 3117

Cross-Country Emerging Markets Analysis

**Jose Ramón Perea**  
jramon.perea@grupobbva.com  
+34 91 374 72 56

**Will China's tightening prompt a hard landing?**

There is some concern in the market that the surge in Chinese inflation will prompt the Central Bank to tighten monetary policy in excess, increasing the risk of a hard landing. The required reserve ratio (RRR) was raised by 50 bps last week, and announced a further 50bp increase this week. Moreover, the government announced a set of measures to curb price increases, including possible price controls. We expect further hikes in RRRs of an additional 100-150bps during the coming year, and at least two more 50bp rate hikes in 2011, along with gradual currency appreciation. To contain inflationary expectations, we would not rule out a rate hike before the end of the current year, and odds are increasing of cumulative interest rate hikes of as much as 100bp by the end of 2011. But given the strength of growth momentum, a supportive fiscal stance and real interest rates at low levels, we do not anticipate such tightening to affect overall growth adversely—our projection remains 10.1% and 9.2% for 2010 and 2011 respectively. In our view, quantitative instruments on lending have a bigger impact on growth and inflation than changes in lending and deposit rates.

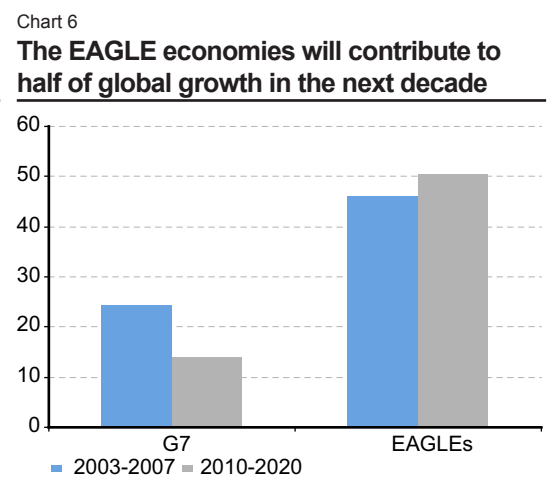
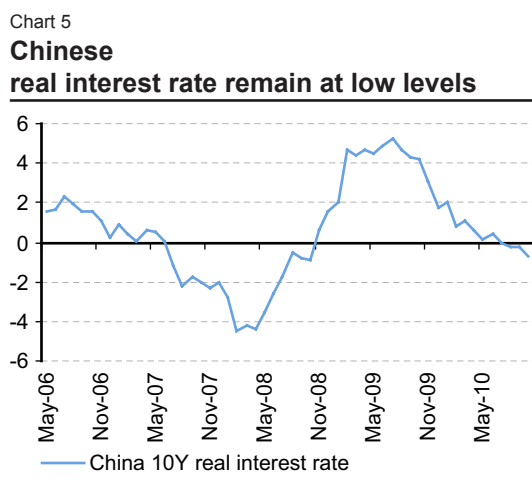
**BBVA Research just introduced a new group of countries –EAGLES– which are to become the largest contributors to global growth**

As the developed world pays the toll for years of financial excess, emerging markets are moving ahead with a strong recovery. Some of this difference is purely cyclical but not all. Aware of this turning point in the engines of global economic growth, the concept of EAGLEs (Emerging and Growth Leading Economies) seeks to identify countries whose individual contributions to world growth in the next 10 years is expected to match or exceed the average of the largest developed economies (excluding the US). With this motivation, our methodology has several advantages over previous classifications: First, it is based on objective measures of performance. Thus, it is a dynamic concept, allowing for changes in membership as time progresses. Initially, we identify ten BBVA Eagles, ordered from the largest to the smallest contributor to global growth: China, India, Brazil, Korea, Indonesia, Russia, Mexico, Turkey, Egypt and Taiwan. [BBVA EAGLEs](#).

**Ireland closer to a rescue ...**

The increased tension in the European sovereign debt markets in the last two weeks has revived the possibility of further rescue plans in Europe, this time with the market focusing on the Irish and Portuguese economies. The situation in Ireland is the most acute due to grave problems in the banking sector and the need for severe fiscal tightening (Portugal has also been affected by the recent spike in sovereign debt). Some solutions to the Irish rescue package have been proposed during the week: 1) a European rescue mechanism (which includes: the European Financial Stability Fund (EFSF), the European Financial Stability Mechanism (EFSM) and the financial assistance available from the International Monetary Fund (IMF)); 2) a British solution by which the UK will make bilateral loans to Dublin; and 3) a financial solution by which the Irish government would propose to borrow money for the banks supported by a guarantee from the ECB. In the end, a joint EU-ECB-IMF rescue package is the most likely option (we estimate the cost of this potential rescue would be around EUR 100-150 bn) according to declarations from Ireland's central bank Governor who revealed his expectations were that "the Government will accept a "very substantial" loan amounting to "tens of billions" of euros from the EU and the IMF. All in all, we expect that a final solution won't be reached at least until the next week, when financial conditions for the aid package will be unveiled.

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Economic Analysis

Europe  
**Elvira Prades**  
elvira.prades@grupobbva.com  
+34 91 537 79 36

**Agustín García Serrador**  
agustin.garcia@grupobbva.com  
+34 91 374 79 38

US  
**Hakan Danis**  
hakan.danis@bbvacompass.com  
+1 713 843 5382

Asia  
**Serena Wang**  
serena.wang@bbva.com.hk  
+852 2582 3194

Mexico  
**Julián Cubero**  
juan.cubero@bbva.bancomer.com  
+52 5556214143

## Calendar: Indicators

### Eurozone: Flash PMI Composite (November, November 23rd)

<b>Forecast:</b> 53.0	<b>Consensus:</b> 53.6	<b>Previous:</b> 53.8
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**Comment:** The composite PMI index is expected to decline further in November, though the drop should be moderate as in October, after the sharp correction observed in September, showing a more picture of slowing economic activity in Q4, but without a rapid deterioration. The expected fall in November should be reflected both in services and manufacturing, although the latter should remain more resilient. **Market Impact:** A sharper than expected drop of PMI index could be reflecting an environment with renewed strains in financial markets and high uncertainty about the sustainability of public finances.

### Eurozone: Industrial new orders (September, November 24th)

<b>Forecast:</b> -2.5% m/m	<b>Consensus:</b> -3.0% m/m	<b>Previous:</b> 5.4% m/m
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**Comment:** Following the strong rebound experienced by industrial exports in August, orders are expected to have dropped in September. Excluding the volatility of the series, the 3-months moving average is showing that growth of industrial orders clearly slowed over Q3, somewhat expected after the strong rebound in the previous quarter. Nevertheless, October data from confidence surveys showed that orders, especially from abroad, surged again, pointing to some resilience from the hard series in coming months. **Market Impact:** A larger decline than expected could be interpreted by the markets as a waning in the support of exports due to the global economic slowdown and the impact of the strengthening of the euro.

### US: Personal Income and Spending (October, November 24th)

<b>Forecast:</b> 0.4%/m/m, 0.5%/m/m	<b>Consensus:</b> 0.4%/m/m, 0.4%/m/m	<b>Previous:</b> -0.1%/m/m, 0.2%/m/m
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**Comment:** U.S. personal income and disposable personal income decreased by 0.1% (\$16.8bn) and 0.2% (\$20.3bn) in September, respectively. On the contrary, personal consumption expenditures (PCE) increased by 0.2% while real PCE increased 0.1% in September. However, recent indicators including retail sales indicate high consumption in October. **Market impact:** Significantly better-than-expected figures would imply that the PCE would continue to positively contribute to economic growth in 4Q10 and welcome by the markets.

### US: Durable Goods Orders (October, November 24th)

<b>Forecast:</b> 0.1%/m/m	<b>Consensus:</b> 0.0%/m/m	<b>Previous:</b> 3.5%/m/
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**Comment:** Durable goods orders surprised to the upside in September (3.5% vs. 1.8%); however, the increase was driven by orders of nondefense aircraft and parts, which surged 105% in the month. Excluding transportation, orders declined by 0.4%. We expect that durable goods orders edged up slightly in October. **Market impact:** Although the durable goods orders data is highly volatile from month to month, the release will be the first monthly durable goods estimate for 4Q10. Therefore, stronger than expected new orders would indicate a strong economic activity in 4Q10.

### Singapore: CPI inflation (October, November 23rd)

<b>Forecast:</b> 3.48% y/y	<b>Previous:</b> 3.67%/y/y
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**Comment:** Inflation is expected to ease with the appreciation of the currency, especially after the monetary authority tightened policy last October through a steepening in the slope of SGD's appreciation path. After peaking in Q2, the pace of property price increases has eased thanks to tightening measures in the housing market. **Market impact:** A higher-than-expected CPI reading would raise expectations of further currency appreciation, and could fan regional fears of rising inflation especially after the upturn in China.

### Mexico: Monetary Policy Decision (November 26th)

<b>Forecast:</b> no change (4.5% fondo)	<b>Consensus:</b> 4.5%	<b>Previous:</b> 4.5%
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**Comment:** no movement in monetary policy rate next Friday is the general consensus, analyst (all but one that forecast -50 bp) and markets (short-term curve have moved recently to positive slope from negative one). **Market impact:** Assuming no change scenario, market could react to statement's messages, especially to those related with exogenous factors as foreign capital inflows and exchange rate evolution. On the latter, Carstens's recent wording not showed concern on undue appreciation.

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## Markets Data

			Close	Weekly change	Monthly change	Annual change
<b>Interest Rates</b> (changes in bps)	<b>US</b>	3-month Libor rate	0.28	0	0	2
		2-yr yield	0.50	0	15	-22
		10-yr yield	2.89	10	35	-47
	<b>EMU</b>	3-month Euribor rate	1.04	-1	2	33
		2-yr yield	1.10	8	10	-23
		10-yr yield	2.70	19	22	-55
<b>Exchange Rates</b> (changes in %)	<b>Europe</b>	Dollar-Euro	1.365	-0.3	-2.1	-8.1
		Pound-Euro	0.86	0.7	-3.5	-5.0
		Swiss Franc-Euro	1.36	1.6	1.2	-9.8
	<b>America</b>	Argentina (peso-dollar)	3.97	0.0	0.2	4.4
		Brazil (real-dollar)	1.72	-0.2	1.3	-0.7
		Colombia (peso-dollar)	1874	0.4	3.0	-4.9
		Chile (peso-dollar)	481	0.0	-0.9	-4.0
		Mexico (peso-dollar)	12.31	-0.2	-0.9	-5.8
		Peru (Nuevo sol-dollar)	2.81	0.1	0.5	-2.6
	<b>Asia</b>	Japan (Yen-Dollar)	83.49	1.2	2.7	-6.1
		Korea (KRW-Dollar)	1133.65	0.5	0.4	-2.2
		Australia (AUD-Dollar)	0.982	-0.3	0.3	7.4
<b>Comm.</b> (chg %)		Brent oil (\$/b)	84.3	-2.4	3.0	9.1
		Gold (\$/ounce)	1343.5	-1.6	1.4	17.4
		Base metals	551.4	-2.1	1.3	19.5
<b>Stock Markets</b> (changes in %)	<b>Euro</b>	Ibex 35	10142	-0.8	-6.9	-13.5
		EuroStoxx 50	2822	0.0	-2.1	-0.4
	<b>America</b>	USA (S&P 500)	1191	-0.7	0.9	9.1
		Argentina (Merval)	3229	0.4	14.5	44.7
		Brazil (Bovespa)	70353	0.0	1.0	6.1
		Colombia (IGBC)	15050	-0.4	-4.2	34.7
		Chile (IGPA)	22874	-0.8	2.4	47.5
		Mexico (CPI)	36198	0.4	3.5	18.0
		Peru (General Lima)	20278	0.1	9.7	39.3
	Venezuela (IBC)	66194	-0.1	-1.1	24.3	
<b>Asia</b>	Nikkei225	10022	3.1	6.9	5.5	
	HSI	23606	-2.5	-0.2	5.1	
<b>Credit</b> (changes in bps)	<b>Ind.</b>	Itraxx Main	100	-3	1	15
		Itraxx Xover	454	-8	-8	-79
	<b>Sovereign risk</b>	CDS Germany	38	0	6	14
		CDS Portugal	409	-42	66	339
		CDS Spain	258	-9	57	175
		CDS USA	39	-2	1	---
		CDS Emerging	218	7	8	-51
		CDS Argentina	690	45	-62	-270
		CDS Brazil	108	4	7	-13
		CDS Colombia	109	4	6	-41
		CDS Chile	77	2	-6	1
		CDS Mexico	114	4	3	-27
CDS Peru	118	2	13	-7		

Source: Bloomberg and Datastream

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