Global

Weekly Watch

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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

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

Strong economic activity

The recent data continues to point to strong economic activity in the main economic areas, despite the current uncertainties. Economic growth in Latin American remains resilient while in Asia there are some signs of moderation in growth, pointing to a transition to a soft landing in China. In the eurozone (EZ) figures showed that activity gained momentum in 1Q 2011. However, growth rates may be peaking in the EU. In the US the US ADP private employment report, jobless claims and non-farm payrolls suggest that the labour market is continuing to improve, fostering expectations that the economic recovery will remain solid.

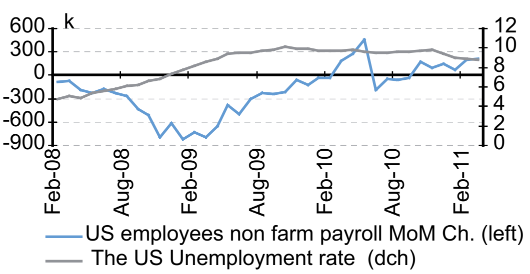
Inflation the main focus of attention

On the inflation front, the EZ CPI accelerated further in March to 2.6%, above our expectations (2.5%). In the US some indicators showed that headline inflation has continued to increase, mainly due to spikes in oil and food prices. Core inflation has started to increase but remains low.

EZ to face its first rate hike, while EM leans on macroprudential policy

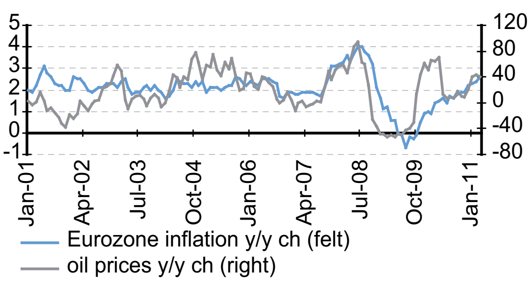
We expect the ECB to hike rates by 25bp next Thursday, as a preventive move (see highlight). Rumours suggest the ECB will set up a new medium-term financing facility to replace the Emerging Liquidity Assistance (ELA) which may be a signal of a resumption of the exit strategy of non-standard measures. However, the ECB's announcement of the suspension of the rating threshold for debt instruments of the Irish government suggests that the new facility will not be announced in the short-term. Additionally, the ECB and IMF welcomed the Irish banks' stress test results, which estimate €24 billion as the amount of required capital. On the other hand, the increase in the hawkish tone of some Fed officials does not change our opinion that the LSAP will to continue to the end of 2011Q2. The NY Fed announced the sale of some MBS held since the start of the financial crisis. This confirms that ongoing market conditions are improving and we are closer to an exit from extraordinary monetary policy. Meanwhile, an increase in capital inflows to EM has prompted China and Brazil to increase their macro prudential-policies (see highlight). Next week, the numerous debt auctions being held in Europe will be one of the main focuses, especially since risks in the European periphery have not faded. Nonetheless, recent events have not had a negative impact on the spreads of Spanish companies.

Chart 1
The US Labour Market is Improving



Source: Bloomberg

Chart 2
Eurozone Inflation and Oil Prices



Source: Bloomberg

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ECB: next week's rate hike…
… the beginning of an unusual cycle.

Inflation in Europe
Second round effects are a distant risk.

Emerging Markets (EM) flows
In the face of increasing inflows, policymakers will restart their macroprudential policy.

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

Global FX
Chief Strategist
Dustin T. Reid
Dustin.Reid@bbvany.com
+1 212 7281707

Global Interest Rates
Interest Rates Europe and USA
José Miguel Rodríguez Delgado
josemiguel.rodriguez@grupobbva.com
+34 91 374 68 97

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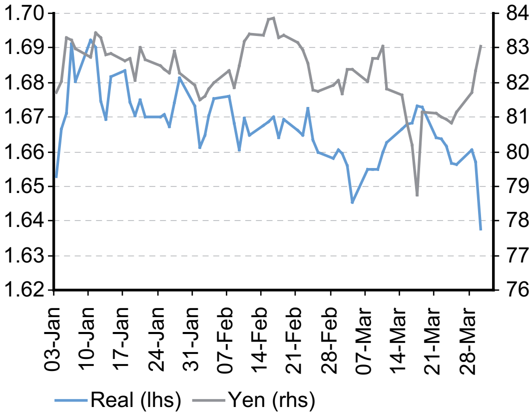
Two Tales of Intervention Success

Coordinated G7 intervention in FX markets continues to be the overriding short-term theme within the G10 space. USDJPY has dutifully stayed above 80.00 and better still has been looking at 83.00 over the last few trading sessions – no doubt to the G7's satisfaction. We found out Thursday morning Japan's Ministry of Finance sold $8.4bn worth of JPY between February 25 and March 29, 2011 to keep JPY artificially depressed not only against the USD but also against other major currencies. With USDJPY continuing to trade close to 83.00 and EURJPY above 117.00, we believe the likelihood of material FX intervention again at these levels is remote and if any intervention were to occur, it truly would come as a market shock. But Japan is not the only economy fighting a highly valued currency, USDBRL continues to push towards fresh cyclical lows trading around 1.6220 on 3/31/11 - well below levels where we know Brazil's Central Bank has previously intervened in FX markets. The move lower in USDBRL comes in the wake of a somewhat dovish Quarterly Inflation Report from Brazil's Central Bank and an increase on taxes to short-term foreign loans via the IOF. We believe there is a decent likelihood Brazilian officials will implement additional structural measures, begin intervening in FX markets via the USD 9bn Sovereign Wealth Fund, or both, in an attempt to curtail recent BRL gains.

Global risk premiums ease

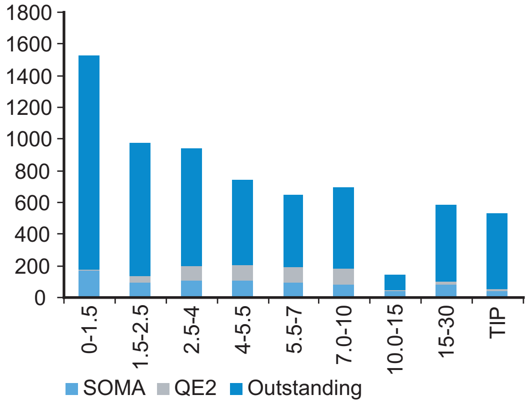
Euro rates have reflected the easing risk premium by edging upward, approaching March highs. However, it has become apparent that they do not have enough momentum to break above this level definitively. We note that this lack of drive has remained despite the recent data which should have pushed up rates (consumer confidence at highs of the last three years and inflation 0.2pp higher than expected). At the short end of the curve this shows, even though it seems clear that the ECB will implement its first rate hike in April, that uncertainty remains over the pace of the subsequent hikes. At the long end, meanwhile, the safe-haven effect that the Portuguese crisis looked set to trigger has not materialised. In the US, the easing safe-haven effect and the resulting upward pressure on rates has been amplified by two factors: i) concerns over inflation have returned, as reflected by the latest University of Michigan data, and the high demand at the last TIPS auction, and; ii) Bullard's statement that he believes the Fed could stop short of USD600bn (he would favour a USD100bn reduction in the outlay). Although this contrasts with opinions of other Fed members (and our own outlook – that the programme will be implemented in its entirety), it may generate some noise. In all, the upper limits of the ranges (3.70% for the 10Y Govt) seem a long way off, and should therefore remain in place.

Chart 3
FX Performance of the Yen and the Brazilian Real vs. the Dollar



Source: Datastream

Chart 4
Share of Fed Treasury Holdings on Total Treasuries Outstanding



Source: Bloomberg and BBVA Research

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Europe
Miguel Jiménez
mjimenez@grupobbva.com
+34 91 537 37 76

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

Financial Scenarios
Javier Amador
javier.amadord@grupobbva.com
(+34) 91 537 3161

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

Highlights

ECB: next week's rate hike, the beginning of an unusual cycle

March's EZ inflation figures along with comments made this week by ECB board members suggest that the Governing Council will follow through with its clearly signalled 25bp rate hike at next week's meeting. This also indicates that the increase is unlikely to be a one-off measure and will rather mark the beginning of an unusual hiking cycle. We expect another quarter point hike in July. But this time too many headwinds still linger and core inflation will remain subdued. Thus, this cycle will likely be different. In our view, the ECB will be careful and move rates very slowly in a two step process. In the first step, it will pre-emptively hike rates to allow some normalization from the "very accommodative" stance which will take official rates to more reasonable levels in one year's time. Next week's and July's hikes will likely be followed by a pause for the remainder of the year before making just two more 25 bp hikes in early 2012, probably in January and April. Hereafter, the ECB would adopt a wait-and-see approach until uncertainties –both in terms of the economic cycle and of the weaknesses of the financial system– fade away. Thus, the ECB official rate would be at 1.5% by the end of 2011 and 2% by the end of 2012 (a more comfortable level). These movements should be enough to fight risks of second-round effects and keep inflation expectations in check. The ECB is constrained by the ongoing problems in the financial system and will not follow a path consistent with a reaction function in a normal economic recovery.

Inflation in Europe: second round effects are a distant risk

One of the key issues that lies behind the expected hike by the ECB in April is the potential for second round effects, from energy inflation to wages and back to inflation. For the eurozone as a whole, the ratio of unused production capacity is still very high and the unemployment rate has barely fallen from its peak, so in principle there is no real pressure for wages to accelerate. The question could be posed especially for those large countries in the eurozone that are growing faster, i.e. Germany and France, where demand pressures could be higher. Here we do not have much evidence of wage acceleration either. The requested wage increases in several German sectors have been sizeable recently, but this also happened after the oil price shock of early 2008 and the rises which were eventually agreed were moderate. This week, for instance, the agreement on wage rises in the Chemical industry was announced, and despite the face figure of a 4.1% increase, the annualised actual figure is of less than 2%, if we consider all the elements in total compensation. Moreover, this year only 30% of the wages will be renegotiated, since the rest are subject to last year's negotiations. Looking also at past episodes of oil price shocks (1990, 1998 and 2008) it is apparent that in Germany the evolution of wages fits more closely that of GDP, and not that of oil prices. In other words, all the evidence suggests that the risks of an inflation spiral following the oil price shock is still far from us.

EM Market flows

In the second half of 2010 emerging market authorities increased efforts to curb inflows to their markets, applying policies such as capital controls and macroprudential policies. However these policies have merely slowed inflows to emerging markets during the 4Q of 2010, although the geopolitical risk in MENA countries has prompted large outflows from emerging market investment funds. Nevertheless, in the past few weeks this trend has turned, and we have seen lower outflows from emerging funds. In our view, investment flows should return to emerging countries, once the probability of unrest in MENA countries spreading to other important oil producer countries such as Saudi Arabia has diminished. In the face of increasing inflows, policymakers will restart their macroprudential policies to tamper with liquidity and prevent currency appreciations. At present we have two good examples of these actions: China is increasing its reserve requirement ratio (RRR) quicker than expected and Brazil announced an increase in the tax on financial transactions of short term foreign loans.

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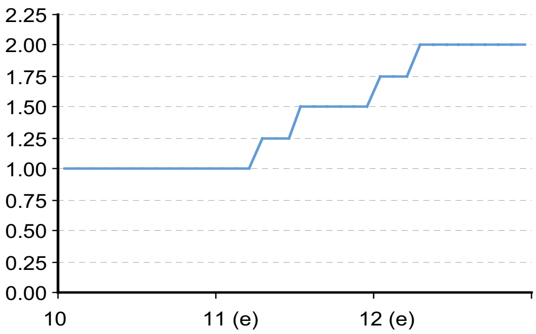
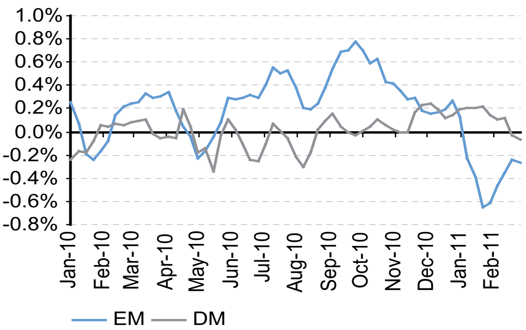
Chart 5
ECB Policy Rate Forecasts



Source: BBVA Research

Chart 6
Weekly Flows to Equity Investment Funds



Source: EPFR

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Europe
Agustín García Serrador
agustin.garcia@grupobbva.com
+34 91 3747938

US
Hakan Danis
hakan.danis@bbvacompass.com
+1 713 843 538

Asia
Jenny Zheng
jenny.zheng@bbva.com.hk

Calendar: Indicators

Eurozone: Industrial prices (February, April 4th)

Forecast: 0.7% m/m	**Consensus:** 0.7% m/m	**Previous:** 0.9% m/m

Comment: Industrial inflation is expected to have increased further in February, driven by the ongoing increase in commodity prices, although at a slower pace than in January. As a consequence of higher input prices, confidence surveys for March showed further evidence of inflationary pressures, but there are no signs of wages increasing, given the still deteriorated situation of the labour market. **Market Impact:** A further acceleration in industrial prices could feed market concerns about tighter ECB monetary policy in order to deal with second round effects.

Eurozone: Retail Sales (February, April 5th)

Forecast: 0.1% m/m	**Consensus:** 0.1% m/m	**Previous:** 0.3% m/m

Comment: Retail sales have probably remained around flat in February, after increasing moderately in January. However, some of the national figures already released showed some downside risk to our forecast, recording a slight decline. In addition, consumer confidence dropped again in March, reverting to Q4 2010 levels, but still remaining above the long-term average. Overall, we think that household spending could have increased slightly at the beginning of the year, supported by the slight improvement in the labour market and more aggressive winter sales. **Market impact:** A very negative surprise could be interpreted as a weaker domestic demand than expected, thus raising doubts about the pace of the recovery in coming quarters.

US: ISM Services (March, April 5th)

Forecast: 59.5	**Consensus:** 59.9	**Previous:** 59.7

Comment: In February the Institute for Supply Management (ISM) Non-Manufacturing Index climbed 0.3 pp and reached 59.7%. The data indicate that the economic activity in services sector continued to increase compared to previous month and business activity has increased in the last 19 months. New orders index declined slightly but remained above 50, indicating expansion in new orders. Furthermore, recent increases in consumer and producer prices are also consistent with the ISM Prices Index which increased by 1.2pp to 73.3%. This indicates that the prices in services increased at a faster rate in February. We expect that both prices and economic activity in non-manufacturing sector index will continue to increase in March. **Market impact:** Market participants are expecting ISM non-manufacturing index remain above 50. However, if the index came below that level, volatility in financial markets would likely to increase and participants would start to question the strength and sustainability of the recovery.

US: Initial Jobless Claims (April-2, April 7th)

Forecast: 380K	**Consensus:** 384K	**Previous:** 388K

Comment: Both initial and continuing jobless claims continue to indicate gradual improvement in the labor markets. Latest data show that initial and continuing claims are at 388K and 3.7mn, respectively. Although initial claims increased slightly from the previous week, they are still below 400K and indicate that job creation will continue in the coming months. These levels were consistent with March nonfarm payroll data which have increased by 216K. We expect that ongoing improvement in the labor markets will continue as the U.S. economy experiences robust economic growth. However, recent developments in the Middle East North Africa (MENA), increasing oil prices and sovereign debt crisis in Europe might slow down this process. We forecast slight decline in claims next week. **Market impact:** If initial jobless claims drops below 375K, it would signal significant progress in labor markets, support robust economic growth and push equity prices higher.

Philippines CPI inflation

Forecast: 4.5% y/y	**Consensus:** 4.5% y/y	**Previous:** 4.3% y/y

Comment: Until last week, the Philippines' central bank was the last holdout in Asia to begin tightening monetary policy, with a 25bp interest rate hike to 4.25% announced on March 24. The central bank moved in response to rising inflation, which has been exacerbated by recent increases in food and oil prices. The central bank is seeking to keep inflation to within its 3-5% target range, but with core inflation on the rise from demand pressures (3.5%y/y in February) and the central bank's forecast for 2011 headline inflation (annual average) recently increased from 3.6% to 4.4%, the target is at risk. **Market impact:** A faster than expected acceleration of inflation could trigger further interest rate hikes in the near term (we currently anticipate three more hikes this year).

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				Close	Weekly change	Monthly change	Annual change
Interest Rates	(changes in bps)	US	3-month Libor rate	0.30	-1	-1	1
			2-yr yield	0.88	15	19	-23
			10-yr yield	3.50	6	3	-45
		EMU	3-month Euribor rate	1.25	5	15	61
			2-yr yield	1.83	10	29	88
			10-yr yield	3.39	11	19	30
Exchange Rates	(changes in %)	Europe	Dollar-Euro	1.407	-0.1	1.4	4.3
			Pound-Euro	0.88	0.2	3.6	-0.8
			Swiss Franc-Euro	1.31	1.5	2.7	-8.4
		America	Argentina (peso-dollar)	4.05	0.3	0.6	4.6
			Brazil (real-dollar)	1.62	-2.1	-2.1	-8.0
			Colombia (peso-dollar)	1863	-0.4	-2.7	-2.9
			Chile (peso-dollar)	477	-0.3	-0.1	-8.5
			Mexico (peso-dollar)	11.85	-1.2	-2.1	-3.7
			Peru (Nuevo sol-dollar)	2.81	0.5	1.2	-1.2
		Asia	Japan (Yen-Dollar)	84.67	4.0	3.7	-10.5
			Korea (KRW-Dollar)	1089.25	-1.9	-3.0	-3.2
			Australia (AUD-Dollar)	1.033	0.8	1.6	12.4
Comm.	(chg %)		Brent oil ($/b)	117.4	1.6	0.9	39.8
			Gold ($/ounce)	1416.6	-0.9	-1.2	26.5
			Base metals	624.7	-0.3	0.4	23.6
Stock Markets	(changes in %)	Euro	Ibex 35	10671	-0.4	0.3	-3.6
			EuroStoxx 50	2949	1.3	-0.3	-1.0
		America	USA (S&P 500)	1331	1.3	1.7	13.0
			Argentina (Merval)	3388	1.2	-1.1	42.7
			Brazil (Bovespa)	68768	1.5	2.2	-3.3
			Colombia (IGBC)	14470	-0.6	-4.4	19.4
			Chile (IGPA)	22116	1.8	4.7	24.4
			Mexico (CPI)	37633	2.3	2.1	13.1
			Peru (General Lima)	21917	-1.5	-3.5	44.9
			Venezuela (IBC)	70322	-1.8	4.0	20.5
		Asia	Nikkei225	9708	1.8	-7.5	-14.0
			HSI	23802	2.8	3.3	10.5
Credit	(changes in bps)	Ind.	Itraxx Main	102	-1	1	24
			Itraxx Xover	384	-1	-7	-39
		Sovereign risk	CDS Germany	45	-2	-4	13
			CDS Portugal	580	33	117	435
			CDS Spain	233	7	-9	115
			CDS USA	41	-1	-5	---
			CDS Emerging	206	-3	-16	-16
			CDS Argentina	592	-8	-56	-296
			CDS Brazil	111	-3	-7	-14
			CDS Colombia	108	-5	-13	-37
			CDS Chile	61	-4	-18	-25
			CDS Mexico	105	-2	-9	-8
			CDS Peru	138	12	23	13

Source: Bloomberg and Datastream

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