

# Weekly Watch

Global

Madrid, 1 July 2011  
**Economic Analysis**

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

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

**María Martínez Álvarez**  
 mariamartinezalvarez@grupobbva.com  
 +34 91 537 66 83

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

## Short-term relief

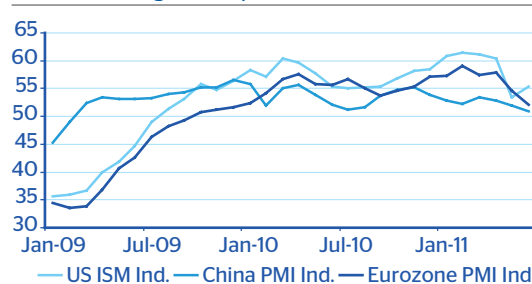
The Greek government finally won enough parliamentary support to pass the Medium-Term Fiscal Strategy Programme, thus giving the government the green light to implement a EUR78bn package of tax increases and asset sales (see highlight). Financial markets rallied on the positive news coming from Greece. European peripheral sovereign spreads have tightened across all maturities; the Spanish 10 year bond spread against the German bond has tightened 48bp this week. Nevertheless, for uncertainties to subside there are still some issues which must be clarified, such as the details of the second aid package and how private sector involvement (PSI) is to be defined in the programme. Regarding the PSI, official and private sector positions must converge in order for private investment to be guaranteed. Furthermore, rather than resolving the Greek solvency problem, the French proposal seems to have simply bought Greece time to adjust its economy. Moreover, the new debt coupons, ranging between 5.5% and 8%, do not provide the possibility of reducing Greece's debt as real interest rates are to remain above real GDP growth.

## Economic data no longer consistently surprising on the downside

This week's economic data continues to show that the economic recovery is slowing down. However, there are initial signs which indicate that the weakness is reversing and that growth could bounce back in 3Q11. Business activity indicators point to an improvement over the next few months. Industrial production in Japan increased 5.7% y/y in May after contracting 1.6% in April. Additionally the 2Q11 Tankan survey suggests that large Japanese companies will boost capital spending by 4.2% in 2011, exceeding analysts' expectations of 2.4%. In all, this suggests that Japanese industrial activity is rebounding following the shock suffered by the earthquake and this in turn is paving the way for a rebound in industrial activity in other countries which have been affected much more than expected by the supply chain distortion. In fact, the US ISM beat expectations, rising to 55.3 in June from 53.5, pointing towards a more solid growth going forward. This data supports our view that the US economic slowdown is temporary. In contrast, Chinese PMI decreased in June to 50.9 from 51.5 (the slowest pace in more than two years), but faced with inflation pressures and with monetary aggregates falling short of their targets, two more rate hikes still seem likely. Eurozone surveys also came in weaker than expected.

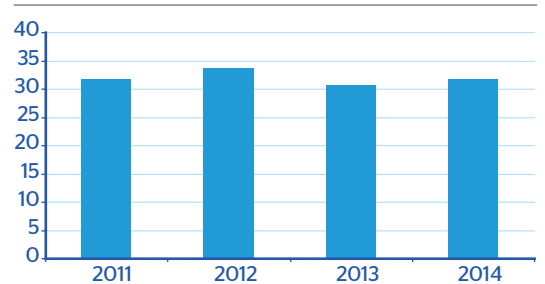
**Next week**, markets will focus on the ECB monetary policy meeting (see highlight) and the US June non-farm payrolls. June Non-farm Payrolls.

Chart 1  
**Manufacturing Activity**



Source: Bloomberg

Chart 2  
**Greek Government Debt Amortization (EUR bn)**



Source: Datastream and Bloomberg

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## Highlights

### ECB sticking to “normalisation” until it feels more comfortable

After the expected hike next week, we expect an additional 25bp increase this year.

### Greece: uncertainty will not disappear

Greece will continue to be examined quarterly to check that it is on track to meet targets.

### China's Audit Office puts local government debt at 22% of GDP

New official data regarding local government debt came in lower than some market estimates.

Markets Analysis

Markets

Macro Europe Strategy

Chief Strategist

**Nicolás Trillo**  
nicolastrillo@grupobbva.com  
+34 91 537 84 95

Global FX

Interest Rates Europe and USA  
**José Miguel Rodríguez Delgado**  
josemiguelrodriguez@grupobbva.com  
+34 91 374 68 97

FX Europe

**Victoria Torras**  
victoria.torras@grupobbva.com  
+34 91 537 73 86

Global Credit

Credit Europe  
**Antonio Vilela**  
antoniovilela@grupobbva.com  
+34 91 374 56 84

Global Equity

Strategy  
**Beatriz Tejero**  
beatriztejero@grupobbva.com  
+34 91 374 46 61

**Positive impact in rates of a lower risk premium in Greece**

The tightening prior to the approval of the austerity measures in Greece should correct over the next few days. The parts of the curve which we think have the most scope are:

- i. Core/periphery spreads: these should have some scope to correct further from their recent all-time highs, following the trend seen in recent hours.
- ii. Financial risk premium: asset swaps, particularly at the short end, should decline (back to around 53 bp in the euro 2Y). Also, market expectations for euro and dollar inter bank rates should ease (the front 3M futures contracts for both rates recently widened on risks of a possible up tick in the bank liquidity premium).
- iii. Expectations for ECB action: the market, which had been reducing its expectations of ECB tightening while it awaited events in Greece, could correct its forecasts back up. At the same time, the short end will become more sensitive to macro data, especially to inflation-related data.
- iv. Fiscal factors: in the US, the long terms of the Treasury have been largely driven by flight-to safety over the last 4-5 weeks, with fiscal risks taking a back seat. Given a possible reduction in the global systemic risk premium and with the debt cap deadline looming (2 August) these could now come back to the fore.

**Positive momentum in other markets too**

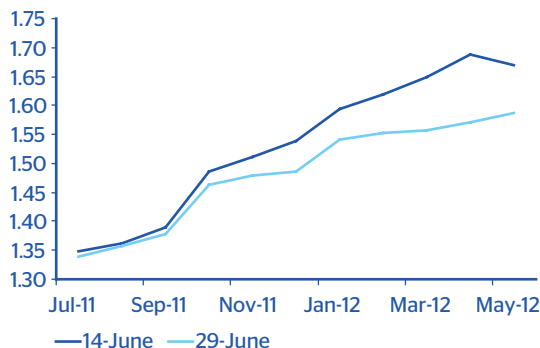
In currencies, we have witnessed a return in risk appetite, something which has benefited currencies which are sensitive to risk. Furthermore, we would highlight that EURUSD has also been favoured by the expectation of a further 25bp hike in interest rates in July by the ECB. The reduction in the market's net-long position of the last few weeks has also done its work, boosting the EURUSD's increases by more than 4 big-figures during the last week and taking it above 1.4500. Over the next few weeks, following the end of the first half of the year and the 4 July public holiday in the USA, the market may start to concentrate on macro figures related to the health of the North American economy and the vote on the US debt ceiling.

The primary market was quiet as a consequence of current market volatility, although activity is expected to normalise following the easing of the Greek situation, mainly through the issue of high-quality assets such as covered bonds. Regarding senior debt of financials, although it has become somewhat less attractive than other, higher quality assets, such as covered bonds, a certain number of private placements have been reported with a degree of success, and following the summer, a new window of opportunity is expected to open up for senior debt issuers.

In equity, Banks have shaken off the pressure which they have been under for weeks. Meanwhile, on the other - and more long term - the reduction of the market risk premium, due to the lower probability of Greece going bankrupt, is pushing down the IRR of Spanish 10ydebt. This implies that in general equity valuations could improve considerably.

Chart 3

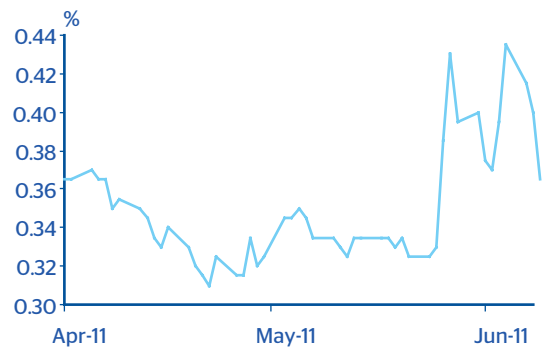
**Market forecasts for Eonia rates\***



\* Discounted on the Eonia Swap curve  
Source: Bloomberg and BBVA Research

Chart 4

**Futures on 3M Libor September 2011 maturities**



Source: Bloomberg and BBVA Research

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## Economic Analysis

## Highlights

*Financial Scenarios***Javier Amador**

javier.amadord@grupobbva.com  
+34 91 537 3161

*Europe***Miguel Jiménez**

mjimenez@grupobbva.com  
+34 91 537 37 76

*Asia***Xia Le**

xia.le@bbva.com.hk  
+852 2582 3132

**ECB sticking to “normalisation” until it feels more comfortable**

Despite heightening tensions regarding Greece in early June, the ECB signalled an interest rate rise in July at its monthly meeting. This week, Mr. Trichet reiterated that the central bank was “in a state of strong vigilance” and repeated that risks related to the growth outlook remain broadly balanced, whilst risks regarding medium-term inflation are on the upside. This near-confirmation of a 25bp rate hike comes in a context of lower than expected economic and inflation data. Moreover, although the approval of fiscal measures in Greece removed near-term uncertainty, a permanent solution to the underlying problems is still not in sight. The fact that with all the lingering uncertainties the ECB is sticking to “normalisation” regarding monetary policy from a stance that they perceive as still “too accommodative” is an indication that the ECB wants to reach an interest rate level that they feel more comfortable with. Given that inflation will remain above the target for the rest of the year and that they feel uncomfortable with the current policy rate level, we expect an additional 25bp increase this year (after the expected hike next week), likely to come in December and one further rise in March 2012 before they pause at 2.0% for the remainder of 2012. We believe that once the ECB reaches that 2.0% level, it will feel more comfortable in a context of: i) slower growth; ii) stable inflation expectations; iii) an absence of second-round effects; and iv) in which the underlying problems of the financial crisis are still unresolved. Thus, in our view, it will see no need to continue with the current pre-emptive approach and will not take any action for some time before resuming the course of policy normalization once uncertainties are dispelled.

**Greece: uncertainty will not disappear**

After the approval by the Greek parliament of key laws to implement further fiscal adjustment measures and launch privatisations, as well as the strong signals provided by the news that a new EU rescue package amounting to around EUR85bn - including private sector participation - will be released over the coming days, the IMF and EU look set to provide the pending tranche of the current loan to Greece. This should enable Greece to face forthcoming payments (the next one is due on 15 July). If the details of private sector participation are worked out properly, risk of a disorderly restructuring of Greek debt in the short term will have disappeared, so stress is likely to be reduced for the rest of periphery countries in coming weeks. However, the outlook for the next few quarters is not free of risks. On one hand, the risk of restructuring in the long term remains, whilst on the other, Greece will continue to be submitted to quarterly examinations by the troika. If the country does not meet the established targets, the IMF will not be able to disburse its loan and hence a situation as the one experienced during the past two weeks could be repeated. If this was to happen, there would be less margin for new adjustment measures in Greece given the country's political situation. This is why the key tasks now in Greece are to implement the two main pillars of the new measures: i). privatization; and ii) the development of a modern tax administration that is able to fight against tax fraud and collect taxes efficiently. Although the Greek finance minister has set these two tasks as the main challenges, it is also true that both these areas are the ones which have come up against the most resistance in the country. In short, despite the relief provided by last week's news, the uncertainty will not disappear over the next quarters.

**China's Audit Office puts local government debt at 22% of GDP**

On Monday, China's National Audit Office (NAO) announced that total local government debt stands at RMB10.7trn (22% of GDP), of which about half consists of obligations via local government financing vehicles (LGFVs). The figure for LGFV loans is much lower than in previous estimates by official sources and the market. We believe that the difference is due to varying definitions and concepts rather than a deliberate attempt to distort the picture. Nonetheless, the new data may be useful in assessing the true size of outstanding LGFV debt, which we now estimate to be around RMB14trn as of end-2010, equivalent to 35% of GDP. Not all of this debt bears an explicit local or central government guarantee (the reason why the NAO estimates local government debt from these vehicles at just RMB5.0trn). The new estimates generated a flurry of exchanges in the media about the true public debt burden in China, which some estimate to be as high as 80% of GDP, including both central and government debt. While such a level does not pose a near-term financing problem, if allowed to increase further, it could result in local government debt-servicing problems and NPLs in the future. In recent weeks, reports of a proposal by the Ministry of Finance have been circulated saying that the central government and banks will have to bear some of this debt. In our view, a positive take on this situation is that officials are aware of the risks and are taking steps to address them.

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Europe

**Agustin Garcia Serrador**  
agustin.garcia@grupobbva.com  
(+34) 91 374 79 38

US

**Boyd Nash-Stacey**  
Boyd.Stacey@bbvacompass.com  
+1 713 881 0655

Asia

**Chen Fielding**  
fielding.chen@bbva.com.hk  
+852 25823297

Calendar: Indicators

Eurozone: retail sales (May, 7 July)

Forecast: -0.9% m/m	Consensus: -1.0% m/m	Previous: 0.9% m/m
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**Comment:** retail sales are expected to have declined in May, after rebounding in April, partly due to the Easter holidays. National figures already released for Germany and France have shown a significant decline in household spending in May. Nevertheless, consumer confidence remained broadly stable in 2Q, while underlying consumption drivers have not worsened. Overall, private consumption should have remained subdued in the eurozone as a whole in Q2, although data up to May suggests that it may have decelerated slightly over 1Q. High uncertainty regarding the economic outlook over the coming quarters, linked to the debt crisis in the periphery, should continue to weigh on consumer confidence. **Market impact:** a sharp drop in retail sales could be interpreted by markets as an increase in uncertainty about the recovery of household spending. This could thus fuel doubts about the role of domestic demand in supporting a more sustainable recovery.

Germany: industrial production (May, 7 July)

Forecast: 0.4% m/m	Consensus: 0.5% m/m	Previous: -0.6% m/m
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**Comment:** We expect industrial production to have increased in May, after having declined in Mar. Soft data for 2Q suggests that the industrial recovery continued slowing, though confidence levels remained in expansionary territory. In addition, despite May's anticipated increase, industrial output has already slowed from 1Q. Looking forward, we think that the industrial sector's recovery remains on track, but looks set to take place at a more moderate pace, after the strong but unsustainable growth recorded last year. Upbeat exports data, for which data for May will also be released next week, should continue to support the industrial sector over the coming quarters, especially from emerging economies. **Market impact:** a very negative surprise could be interpreted by markets as a quicker slowdown in economic growth than anticipated.

US: ISM non-manufacturing index (June, 6 July)

Forecast: 54.0	Consensus: 53.5	Previous: 54.6
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**Comment:** the ISM Non-Manufacturing composite index increased 1.8pp in May to 54.6. A composite index above 50 indicates that the service sector is expanding. Employment in the service sector continues to grow, as suggested by the employment index which increased from 51.9 to 54.0 in May. However, the general slowdown in economic activity and high commodity prices will drag down the June index, but we expect the report to still show positive economic growth. **Market impact:** a positive report could indicate employment creation during June in the non-manufacturing sector. Markets should respond positively to higher than expected figures.

US: non-farm payroll and unemployment rate (June, 8 Jul)

Forecast: 65k, 9.1%	Consensus: 83k, 9.1%	Previous: 54k, 9.1%
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**Comment:** the previous month's employment report indicated non-farm payroll employment is decelerating. The non-farm payroll increased by 54k jobs, on a seasonally adjusted basis, but added 178k fewer jobs than in May. Furthermore, last month's report was below the previous three-month average of 220k. Continued fiscal cuts at the federal, state, and local levels are likely to negatively impact non-farm payrolls in June. Since the number of initial jobless claims remains relatively constant, we expect non-farm payrolls to modestly increase by 65k. In addition, unemployment duration is still high, suggesting that the unemployment rate will remain stable for June. **Market impact:** a series of weaker than expected data has increased market anxiety. If the employment situation deteriorates, we would expect investors to react negatively.

Australia: unemployment rate (June, 7 July)

Forecast: 4.9%	Consensus: -	Previous: 4.9%
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**Comment:** although Australia's unemployment rate has been stable in recent months, the participation rate and full-time jobs figures have been declining, along with GDP growth. The employment data will be watched as an indicator of the health of the economy and by the RBA for the future course of monetary policy. **Market impact:** stronger-than-expected employment data would raise market sentiment, and could increase expectations of RBA rate hikes, leading to a stronger Australian dollar.

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## Markets Data

			<b>Close</b>	<b>Weekly change</b>	<b>Monthly change</b>	<b>Annual change</b>
<b>Interest Rates</b> (changes in bps)	<b>US</b>	3-month Libor rate	0.25	0	-1	-29
		2-yr yield	0.47	14	4	-16
		10-yr yield	3.16	30	22	19
	<b>EMU</b>	3-month Euribor rate	1.56	3	12	77
		2-yr yield	1.63	28	2	97
		10-yr yield	3.02	18	3	44
<b>Exchange Rates</b> (changes in %)	<b>Europe</b>	Dollar-Euro	1.447	2.1	0.5	15.3
		Pound-Euro	0.90	1.8	2.7	9.4
		Swiss Franc-Euro	1.23	3.4	1.3	-8.3
	<b>America</b>	Argentina (peso-dollar)	4.11	0.3	0.5	4.4
		Brazil (real-dollar)	1.56	-2.3	-1.5	-12.2
		Colombia (peso-dollar)	1767	-1.4	-1.3	-6.3
		Chile (peso-dollar)	466	-1.5	-0.3	-13.5
		Mexico (peso-dollar)	1168	-1.7	0.3	-10.7
		Peru (Nuevo sol-dollar)	2.75	-0.5	-1.1	-2.8
		Japan (Yen-Dollar)	80.92	0.7	0.0	-7.7
	<b>Asia</b>	Korea (KRW-Dollar)	1066.68	-1.3	-1.0	-13.5
		Australia (AUD-Dollar)	1.069	1.7	0.0	27.0
<b>Comm.</b> (chg %)		Brent oil (\$/b)	109.9	4.5	-4.1	53.3
		Gold (\$/ounce)	1482.9	-1.3	-3.7	22.4
		Base metals	600.6	0.6	-1.8	26.9
<b>Stock Markets</b> (changes in %)	<b>Euro</b>	Ibex 35	10376	5.7	0.4	12.2
		EuroStoxx 50	2847	4.8	0.7	12.9
		USA (S&P 500)	1321	4.2	0.5	29.2
	<b>America</b>	Argentina (Merval)	3361	2.2	5.8	51.6
		Brazil (Bovespa)	62261	2.0	-1.8	1.4
		Colombia (IGBC)	14068	-0.5	-2.7	14.0
		Chile (IGPA)	22596	1.8	-1.4	20.0
		Mexico (CPI)	36525	3.3	3.1	16.4
		Peru (General Lima)	18869	-0.7	-7.0	36.5
		Venezuela (IBC)	81358	1.5	0.9	24.9
	<b>Asia</b>	Nikkei225	9868	2.0	1.5	7.2
HSI		22398	1.0	-5.2	12.5	
<b>Credit</b> (changes in bps)	<b>Ind.</b>	Itraxx Main	106	-9	3	-22
		Itraxx Xover	395	-35	23	-174
	<b>Sovereign risk</b>	CDS Germany	43	-2	5	0
		CDS Portugal	745	-97	55	450
		CDS Spain	270	-28	17	28
		CDS USA	50	-3	2	---
		CDS Emerging	212	-22	-5	-64
		CDS Argentina	589	-56	-36	-405
		CDS Brazil	110	-8	4	-30
		CDS Colombia	108	-7	8	-45
		CDS Chile	76	-3	7	-32
		CDS Mexico	107	-8	3	-31
		CDS Peru	131	-18	-15	-6

Source: Bloomberg and Datastream

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