RESEARCH

Weekly Watch
Global

Madrid, 3 June 2011
Economic Analysis

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Markets are adjusting growth expectations

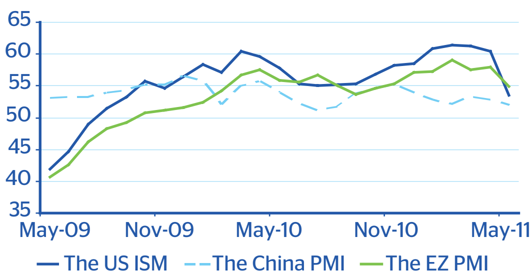
Purchasing Manufacturing indexes decreased in the main economic areas in May, increasing the downside risk in global growth. Nevertheless, China's PMI in May eased to 52 from 52.9, suggesting a mild moderation trend and confirming our baseline scenario for a soft-landing in the Chinese economy. In the EZ, the PMI fell to 54.6 vs. 58 in April. The slowdown was widespread throughout all components and countries, suggesting that the trend in activity is losing steam in 2Q11. However, the sharp fall in the US ISM in May is the reason behind the increase in uncertainty concerning global growth expectations (see highlight). Additionally, the US S&P Case-Shiller National house price index declined 5.1% YoY in March. Prices are currently being affected by the large amount of distressed properties; in fact, in 1Q11, they accounted for one of every three houses sold. This is leading to two different markets: i) the market for distressed properties, where prices are adjusting very strongly; and ii) the non-distressed market (new and existing housing), where prices have remained more stable since the beginning of the economic recovery. Overall, the recent downbeat US data could lower the market's expectations for the US GDP11 growth from a high 3% to between 2.7 and 2.8%.

The Greek crisis seems to be developing in line with our baseline scenario

Throughout this week the idea of a Greek debt restructuring in the short-term has lost some steam while a second EU aid package with more severe bailout conditions is gaining momentum. In this regard, there is talk of Greece speeding up its privatisation programme. Furthermore, there are also talks about other forms of bail-in like options which would offer private bondholders incentives to roll-over maturing debt without triggering a credit event. Recent developments seem to be in line with our baseline scenario for Greece, in which we expect the EU to put maximum pressure on the country to carry out further privatisation and consolidation. In addition, we expect the EU to provide more money to cover financing needs until 2013, reduce interest rates and extend the maturities of official loans at the EU Council meeting on the 23-24 June. As for the disbursement of the next tranche of the IMF loan, which is key to covering imminent financing needs (July), the IMF/EU review indicating whether the Greek programme is on track will be published by mid-June, but the actual decision regarding disbursement by the IMF will be made after the summit, once financing needs have been covered (this is normal practice in IMF programme requirements).

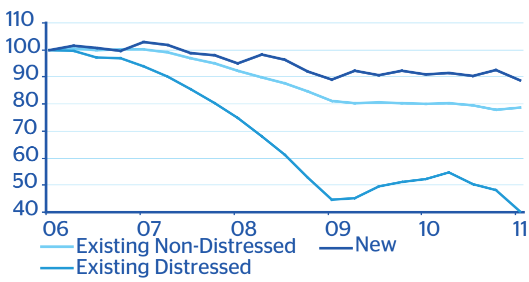
Next week the market's attention will be on the ECB and the developments in the Greek crisis. Notwithstanding the positive inflation surprise in May and signs of statements vis-à-vis an economic slowdown from ECB officials suggested that the ECB continues to lean towards raising rates (we expect this to happen in July, see highlight).

Chart 1
Slowdown in Global Activity



Source: Bloomberg

Chart 2
Housing Price Index



Source: CoreLogic, Census and BBVa Research

Highlights

US economic data points to a weaker than expected 2Q11
This could prompt our average for US GDP11 to be revised down from the current 3%.

The ECB to extend full-allotment and hints at a July hike
The ECB may be forced by market conditions to delay once again.

Brazil: beginning of the low inflation season
Monthly inflation to moderate after very robust growth at the beginning of the year.

Markets Analysis

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Markets

Possible Rotation of EUR Key Drivers

EURUSD continues to consolidate after the circa nine big-figure decline between May 5 and May 17. Since bouncing right off its 100 day moving average and recent lows on May 23, EURUSD has not surprisingly consolidated to trade back above 1.4400 at time of writing. Non-commercial net-long EUR positions have been cut dramatically from more than USD 18bn three weeks ago to just over USD 3bn as of the CFTC's Commitment of Traders report on May 24. With EURUSD positioning now so neutral, one of the key themes and drivers we have been avidly watching since early in the first quarter is now likely to be less so; we see potential, however, for the Greek and Eurozone peripheral debt issue in general to fill the void as key near-term drivers rotate.

Equity to remain range-bound in the short term

The good: consensus EPS estimates for 2011-12 remain sound (on the rise in the USA, improved momentum in Europe) and the long end of the bond yield curve is easing (the Bund and T-Bond are now below 3%), which is creating "value" in equity markets.

The bad: recent data from the US and Europe, and Asia as well, suggests that the slowdown may be somewhat more marked than expected. Meanwhile sovereign risk remains high in Europe, pricing in a high probability of default by Greece (and lower probabilities for Portugal and Ireland), favouring a rise in the equity risk premium.

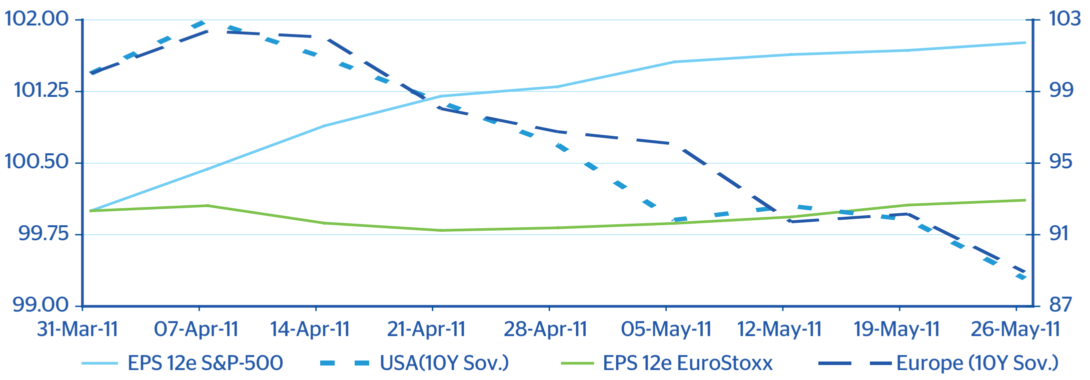
And the ugly: over the last few weeks we have been saying that if European sovereign risk and the global cyclical slowdown continue to generate uncertainty among investors equity markets, particularly in Europe and emerging economies, will remain under pressure in the short term, reinforcing technical resistance levels. The indexes are range-bound (2,750-2,880 for the EuroStoxx-50 and 1,300-1,360 for the S&P-500), testing supports more often than resistances, led by the Financial and Cyclical sectors, and those linked to commodities. In the short term we expect this range to be breached, unless the uncertainty fades. We would pay close attention to macro data – confirming the intensity and duration of the slowdown – and to one-off events such as a new bailout for Greece, the QE2 exit strategy, the European stress test and the solution to the cap on US debt.

Markets are watching Greece

Synthetic indexes have been quite stable so far this week, despite the renewed concern about Greece. In the last few days, rating agencies have been quite active, reviewing the credit ratings of various European countries. Last week, S&P changed the outlook for Italian debt from stable to negative, and Fitch took the same steps with Belgium. Meanwhile, Moody's downgraded its rating on Greece from B1 to Caa1 (3 notches), and kept its outlook negative. This is the fifth time Moody's has downgraded Greece's rating in the last two years. Greece's 5Y CDS is now trading at 1,461bp, which implies a probability of default of 72% for the next 5 years.

On the primary market, Banco Santander and Unicredit have again opened the covered bond market for peripheral issuers this week. In addition, French issuers have been very active, with BNP and Credit Agricole issuing covered bonds. Having said this, as a result of the renewed concern over peripheral European economies, we think that in the near future the primary market issuance will continue to be dominated by national champions. .

Chart 3
USA and Europe: EPS 12e vs 10Y bond



Source: Bloomberg

Home
Highlights
Calendar
Markets Data

Economic Analysis

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Highlights

US economic data points to a weaker than expected 2Q11

US financial markets this week are reacting to indications of slow growth reported by this week's data releases of consumer confidence, the ISM index and ADP hiring. Consumer confidence declined to 60.8 in May, which is down from April's revised 66.0 reading and departs from a consensus forecast of 66.5. Indicators of future expectations moved lower in general. Turning to the manufacturing sector, the ISM index declined more than expected by consensus to 53.5, although this reading is still in expansion territory. One wrinkle in the ISM story is that new orders indicate a slowdown in the future as manufacturers turned more to clearing their backlogs, however, at the same time this may reflect lingering supply-chain disruptions from the Japanese earthquake. Estimates from ADP on private payrolls also disappointed consensus estimates of 210k by clinging on at 38k. It is worth noting, however, that while the ADP is a good indicator of the overall employment growth trend, it does not serve as a perfect guide for non-farm payrolls. For example, January's estimate of 190k by the ADP contrasted sharply with the non-farm payrolls of 94k. Naturally, these three indicators have ramped up the desire for safety and heightened risk aversion. In view of these recent indicators, 2Q11 GDP growth could be around 1.6 to 2% SAAR; not far off the figure registered in 1Q11.This is lower than our baseline scenario and would also support a lower average for 2011 (currently 3%). This data is also consistent with a Federal Reserve which is still uncertain of the sustainability of the recovery and which has no desire to raise interest rates until March 2012. The markets, however, are probably overreacting to this data compared to their prior expectations for rate increases.

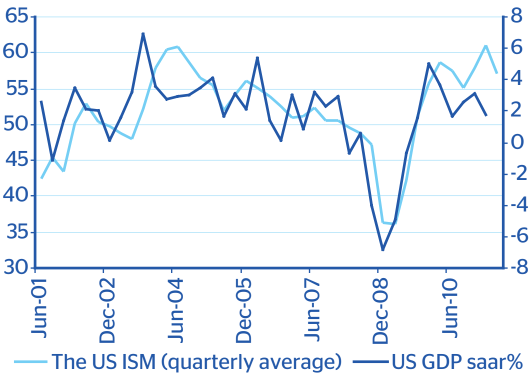
The ECB to extend the full-allotment and hints at a July hike

The ECB is still trying to strike the right balance between pre-emptive hikes and providing sustained support to the financial system. Two major developments have further complicated this difficult task: i) upside risks to inflation have continued increasing; while ii) sovereign risks have rebounded as debt concerns once again spread to core peripherals. These two factors will condition the ECB's decisions. When will the next step be taken? Although the ECB did not tie its hands to delivering a second 25bp move in June if judged appropriate, a rate hike is unlikely as May's wording did not hint for one. Yet, wording may change in June –when the new projections for 2011 HICP inflation will be revised significantly upwards, with a 25bp interest rate increase at the following policy meeting likely. This was hinted at in recent official comments which remain on the hawkish side e.g. Draghi: "In the face of higher inflation risks, there is a greater need to proceed with monetary-policy normalisation". We therefore continue to expect a second move in July. Concerning liquidity provision, it seems likely that in June the ECB may once again be forced by market conditions to delay the resumption of its "phasing-out" of the full-allotment.

Brazil: beginning of the low inflation season

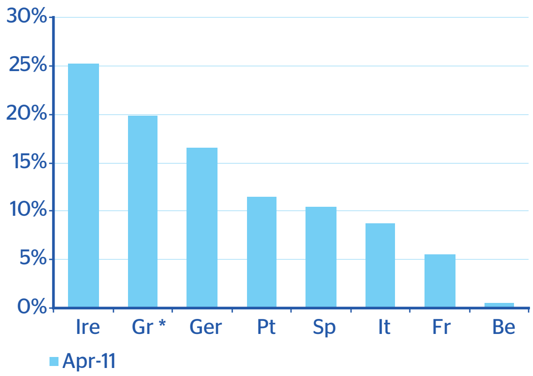
After averaging 0.80% MoM in the first four months of the year, we expect May inflation (to be released on 7June) to come up at 0.45% MoM (market consensus: 0.55% MoM) and continue trending down in the next few months. Seasonal factors, lower pressure from commodity prices, and the moderation of private consumption are behind these expectations. Even though yearly inflation will remain above 6.5% YoY (the upper-limit of the target system), we expect the CB to focus on the moderation of monthly inflation and to implement a 25bp SELIC hike next week (on 8 June) and maybe another one in its subsequent meeting on 20 July. The robust dynamism of labour markets (and second round effects of wages adjustments on inflation) should, however, be carefully watched because if they do not cool down, then monetary policy could end up being more aggressive than currently expected.

Chart 5
US GDP and the US ISM manufacturing



Source: BEA, Institute for Supply Management

Chart 6
ECB: use of MROs and LTRO (% by country)



* April 2011= March data
Source: ECB

Home
Markets
Calendar
Markets Data

Economic Analysis

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Calendar: Indicators

Eurozone: Retail sales (April, June 7th)

Forecast: 0.5% m/m	Consensus: 0.3% m/m	Previous: -0.9% m/m

Comment: Retail sales are expected to have increased in April, after having declined in the previous month, partly due to the Easter holidays. Still, we continue to see retail sales remaining subdued over the coming months as the high uncertainty regarding the economic outlook over the next few quarters, linked to the debt crisis in the periphery, should continue to weigh on consumer confidence. Aggregate figures should continue to hide significant differences between countries, as household spending in the periphery needs to be cut and unemployment remains high. **Market Impact:** a sharp drop in retail sales could be interpreted by markets as an increase in the uncertainty of the recovery of household spending. This in turn could generate doubts about the role of domestic demand in supporting a more sustainable recovery.

Germany: Industrial production (April, June 8th)

Forecast: -0.5% m/m	Consensus: 0.2% m/m	Previous: 0.7% m/m

Comment: we expect industrial production to have declined in April, after rising robustly in the previous quarter, although this was partly affected by the Easter holidays. Looking forward, we think that the industrial sector recovery should remain on track, but should continue to improve at more moderate pace after the strong but unsustainable growth recorded over last year. The German industrial sector should continue to be supported by strong foreign demand, especially from emerging markets. **Market impact:** a very negative surprise could be interpreted by markets as a faster moderation in economic growth than anticipated

US: Jobless Claims (May, June 9th)

Forecast: 420K	Consensus: n.a.	Previous: 422K

Comment: the initial unemployment insurance claims' 4-week moving average declined in the week ending 28 May to 425K from 439.5K, following several weeks of sustained increases. We expect claims to remain relatively stable at 420K in the week ending 4 June. Uncertainty in the labour market and the extension of unemployment benefits early this year should prevent initial claims and the unemployment rate from adjusting rapidly. In our baseline scenario, job creation will continue throughout the rest of the year, but at a moderate pace. **Market impact:** since monthly employment figures were released last week, surprises in jobless claims may not have a major impact on market fluctuations.

US: Import Prices (May, June 10th)

Forecast: -0.5%	Consensus: -0.7%	Previous: 2.2%

Comment: we expect import prices to decrease 0.5% in May following a 2.2% increase in April as oil prices declined during the month. However, this implies an 11.4% YoY rate, up from 11.1% in April. Despite these high YoY rates, the risk of pass-through to core consumer prices is still limited as growth in corporate profits (8.5% in 1Q11) suggests that firms still have room to absorb shocks on prices of imported inputs. **Market impact:** higher-than-expected import prices might cause some anxiety among inflationary risk advocates. However, given the relatively small share of imports in the US economy, producer and consumer price inflation –to be released next week- should provide a better picture of inflation trends in May.

India: Industrial Production (April, June 10th)

Forecast: 5.5% y/y	Consensus: n.a.	Previous: 7.3% y/y

Comment: India has been an example in Asia of moderating growth trends. In a surprising outturn, however, India's industrial production (IP) growth rebounded in March, raising the question of whether the slowdown had bottomed out. In this regard, April IP will be important, although the index is notoriously volatile. We expect growth to remain steady in April, supported by robust exports, consumption demand, inventory restocking and higher infrastructure output. **Market impact:** a lower outturn would dent sentiment and reduce expectations of aggressive interest rate hikes.

Home
Markets
Highlights
Markets Data

Markets Data

			Close	Weekly change	Monthly change	Annual change
Interest Rates (changes in bps)	US	3-month Libor rate	0.25	0	-2	-28
		2-yr yield	0.46	-2	-13	-27
		10-yr yield	3.01	-6	-20	-19
	EMU	3-month Euribor rate	1.44	1	2	73
		2-yr yield	1.66	10	-25	119
		10-yr yield	3.02	4	-28	44
Exchange Rates (changes in %)	Europe	Dollar-Euro	1.449	1.5	-2.4	20.5
		Pound-Euro	0.89	2.6	-1.2	7.1
		Swiss Franc-Euro	1.22	0.2	-4.5	-12.6
	America	Argentina (peso-dollar)	4.09	0.0	0.3	4.2
		Brazil (real-dollar)	1.58	-1.4	-2.1	-14.8
		Colombia (peso-dollar)	1784	-1.8	0.7	-9.2
		Chile (peso-dollar)	467	0.1	0.4	-13.4
		Mexico (peso-dollar)	11.64	0.2	0.1	-9.7
		Peru (Nuevo sol-dollar)	2.76	0.2	-2.2	-3.1
	Asia	Japan (Yen-Dollar)	80.62	-0.2	0.1	-12.1
		Korea (KRW-Dollar)	1078.80	-0.4	0.4	-11.9
		Australia (AUD-Dollar)	1.067	-0.4	-0.8	29.0
Comm. (chg %)		Brent oil ($/b)	115.1	0.0	-5.1	59.6
		Gold ($/ounce)	1533.2	-0.2	1.1	25.7
		Base metals	611.9	0.8	-0.6	30.4
Stock Markets (changes in %)	Euro	Ibex 35	10283	0.2	-4.0	15.2
		EuroStoxx 50	2791	-1.0	-5.4	9.3
	America	USA (S&P 500)	1313	-1.4	-2.6	23.3
		Argentina (Merval)	3150	-3.5	-6.0	44.4
		Brazil (Bovespa)	64218	-0.1	0.9	4.1
		Colombia (IGBC)	14443	0.7	2.6	18.2
		Chile (IGPA)	22981	0.3	1.8	27.3
		Mexico (CPI)	35416	-1.1	-0.3	14.3
		Peru (General Lima)	21736	-2.9	5.1	57.3
		Venezuela (IBC)	80614	0.7	9.3	27.4
	Asia	Nikkei225	9492	-0.3	-5.1	-4.1
		HSI	22950	-0.7	-1.6	16.0
Credit (changes in bps)	Ind.	Itraxx Main	105	1	8	-22
		Itraxx Xover	381	8	25	-208
	Sovereign risk	CDS Germany	39	-1	-1	-10
		CDS Portugal	691	11	68	338
		CDS Spain	254	0	28	-3
		CDS USA	48	-2	5	---
		CDS Emerging	217	0	16	-77
		CDS Argentina	622	7	39	-550
		CDS Brazil	107	0	3	-39
		CDS Colombia	101	-4	2	-68
		CDS Chile	69	0	11	-36
		CDS Mexico	104	-1	7	-40
		CDS Peru	146	20	-1	1

Source: Bloomberg and Datastream

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