

# Weekly Watch

## Global

Madrid, 6 May 2011  
**Economic Analysis**

*Financial Scenarios*  
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## Excessive fears about hard landing

Investors have taken profits in risky assets due to fears of greater tightening in Emerging Asia and the weakness seen in recent economic data in the US and EZ. In our opinion, this outturn in economic indicators confirms our baseline scenario for a moderated pace of recovery in the US and the EZ, although it may cause some downward adjustment in market expectations for a less upbeat path of growth. In the US, the ISM indexes plunged in April. However, the ISM manufacturing index remains at healthy levels (60.4) and the labour market is improving. In the EZ, economic data has showed some moderation in April, but it is still pointing to resilient growth, with greater divergence between countries. The EZ composite PMI for April was confirmed at 57.8, which is considerably high. Meanwhile the fall in retail sales and service PMI index, in March and April respectively, suggested that domestic demand remains weak in the EZ. All in all, we expect next week's EZ 1Q GDP to show an acceleration to 0.6% q/q from 0.3% in 4Q10, steered by a greater positive private investment contribution and lower positive contributions from both net exports and private consumption. We forecast moderation in the growth trend in coming quarters, in light of recent economic data.

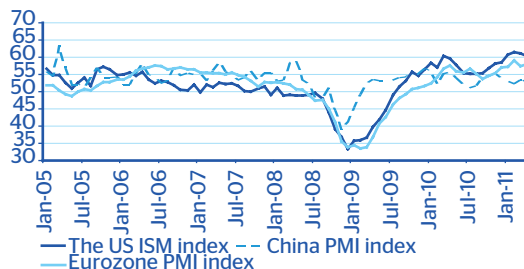
## Overheating risk continues in emerging economies

In Latam countries, the March Chilean GDP proxy (15.2% y/y) and Brazil industrial production showed that strong growth continues. Furthermore, inflation pressures are building in the whole region. In Asia, against the backdrop of robust activity indicators and rising inflation, the region's central banks are stepping up their tightening measures. China's April PMI showed some welcome moderation, helping to allay concerns of a more abrupt tightening. Nonetheless, our baseline scenario of soft landing remains on track (see Highlights).

**A less hawkish tone at the ECB.** The ECB kept the interest rate unchanged at 1.25%, as broadly expected. The ECB's statement was pretty similar to the previous one, and it did not hint at a June rate hike, despite the latter upside surprises in inflation. However, we think that by referring to monetary policy conditions as being "still accommodative" the ECB is laying the ground for wording changes at its June meeting to signal a 25bp interest rate increase at the July policy meeting. We maintain our baseline scenario of only one additional rate hike in 2011, but our bias is still that the ECB might bring forward one of the rate hikes expected in early 2012, taking official rates to 1.75% by year end.

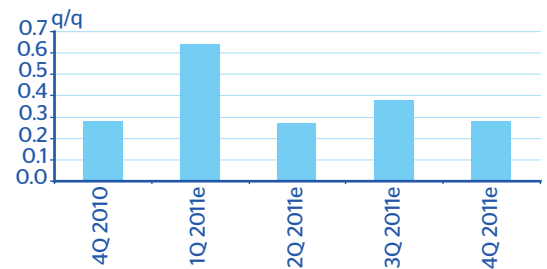
**Next week:** EZ 1Q11 GDP and the April Chinese and US CPI will be the main market focus.

Chart 1  
**Moderation in Manufacturing**



Source: Bloomberg

Chart 2  
**EZ GDP Growth Forecast**



Source: BBVA Research

- Markets →
- Highlights →
- Calendar →
- Markets Data →

## Highlights

### Portugal's rescue programme rightly focused on structural reforms

It is a good reform programme with the right balance of measures.

### China's PMI for April shows a welcome moderation

An easing is welcome given overheating risks, with the focus now on next week's data.

### Euro strength or dollar weakness?

The USD will mean-revert, but drawing from experience, these trends take some time.

Markets Analysis

Markets

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**Decoupling of US-Euro curves leads to positive 10Y spread**

The differing cycles in OECD countries, especially Europe and the US, has led to a marked decoupling of curves. As part of this pattern, the recent rise in commodity prices is having different effects on either side of Atlantic: on one hand Europe remains more focused on inflation risks, while in the US attention is on a possible slowdown in growth rates (the latest data reveal doubts and back up Bernanke’s statement that rates would remain at zero during an “extended period”). This has meant that, in the last week, in view of the possibility of a more hawkish tone from the ECB and following the weak US data, the spread between the 10Y German and US Govt is now positive for the first time in two years.

Contrary to the market’s expectations, Trichet did not include the phrase “strong vigilance” of inflation in his statement. This has tempered the market’s hawkish expectations for the near term (rate hike now not expected until July at the earliest). As the market adjusts to this scenario, spreads vs. the US should return to more normal levels.

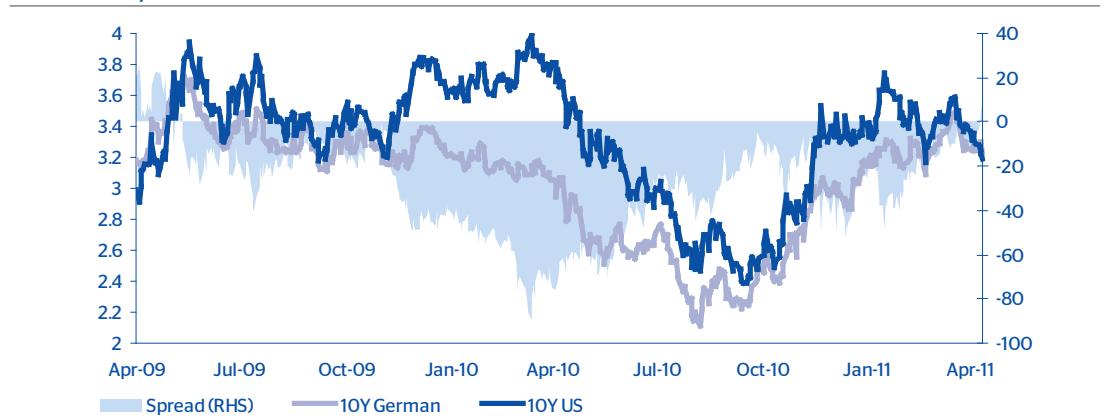
**Extreme Long EURUSD Positioning Haunts Pair in Very Short-term**

As we have noted for the past couple of months, the non-commercial community has remained quite short of USD’s overall, quite long of the EURUSD trade as well as carry trades in general. The ECB’s announcement and press conference Thursday 5/5/11 when it omitted language referring to “strong vigilance” put FX markets in a tizzy. We believe the lack of reference to “strong vigilance” means the ECB will not hike rates in June, but we continue to call for a 25bp hike in July. In reality for FX markets, the details over one 25bp hike in either June or July should not be a material event under normal circumstances, but as we have noted market positioning over the past couple of the months has been anything but normal. The extreme positioning, coupled with profit taking in the oil and commodities sector resulted in a material EURUSD decline post-Trichet’s press conference on 5/5/11 and highlights just how exposed long EUR (and short USD) positions are. We continue to believe the market is focused, among other key drivers, on the decoupling of the ECB and Fed’s rate paths and as such the US dataflow will remain paramount as it pertains to FX in the coming weeks and months. Despite Thursday’s EURUSD decline, if commodity / risk appetite positions continue to unwind from here, we can see EURUSD moving towards our near-term forecasts circa 1.4000; however, continued elevated risk appetite would likely see the move from Thursday 5/5/11 recouped in due course.

**Equity markets price in slightly worse than expected data**

The improvement in earnings momentum in the US and Europe, as 1Q11 results are gradually published, has led to a drop in pressure on 2011-12 forecasts. In addition, the easing Spanish sovereign risk, reflecting a clear decline in correlation with other peripheral countries following the Portuguese bailout, has favoured a drop in the equity risk premium. Nonetheless, the latest macro data, in both the US and Europe are proving disappointing, favouring the formation of a “ceiling” in the short term. In this context, sectors such as Consumer Staples, commodity-linked sectors (Energy and Basic Resources), Financials and Industrials may lead something of a correction from recent highs.

Chart 3  
**10Y Germany vs. 10Y US**



Source: Bloomberg and BBVA Research

- Home →
- Highlights →
- Calendar →
- Markets Data →

Economic Analysis

Highlights

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**Portugal's rescue programme rightly focused on structural reforms**

Portugal has agreed a EUR78bn rescue package with the IMF-EC-ECB troika, which should be approved by the Ecofin on March 16th. We do not expect political hurdles from Finland or other countries to block the approval, and the programme also has the backing of the major Portuguese parties. The conditionality imposes fiscal measures equivalent to 10 pp of GDP overall, in line with previous consolidation plans by the government, but is much more detailed on measures to achieve this, including higher taxes (through lower tax exemptions), lower spending in many areas and an ambitious privatization programme. If growth is not as negative as the troika projects (-2% in 2011 and 2012) the necessary fiscal effort could be less (about 8 pp). In any case, the programme is mainly focused on structural measures, which we think is the correct approach, given Portugal's low growth potential. The labour market reform substantially lowers dismissal costs and improves incentives to work for the unemployed. In addition, the plan includes detailed measures in many areas such as health, network industries, education, the judiciary system, public procurement and housing. The agreement also includes comprehensive measures to address banking sector issues, such as raising capital requirements, and making the system resilient to potential further stress. Overall, it is a good programme of reforms with the right balance of measures, but also a daunting task for the next government after June's elections.

**China's PMI for April shows a welcome moderation**

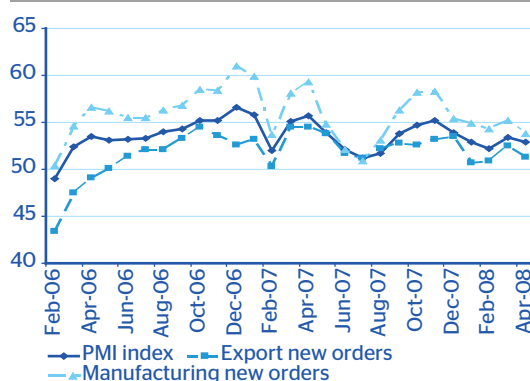
Data released this past week for China's April Purchasing Manager's Index (PMI) showed a moderation in growth momentum. The PMI declined to 52.9%, lower than expected and down from the March reading of 53.4%. Importantly, the PMI reading remains firmly in the expansion zone (+50). The moderation should help allay concerns of overheating. The decline was due in large part to a slip in new orders and a decline in export orders. Market-watchers will be looking to a batch of monthly data due next week on April inflation, investment, retail sales and credit growth for further signs of moderation. With inflation in March having accelerated further, to 5.4%/y (well above the authorities' comfort level of 4%), and Q1 GDP of 9.7% y/y, risks are skewed toward overheating, which has prompted further monetary tightening by the authorities in recent weeks. Market sentiment has been swinging between concerns of overheating on the one hand, and of a hard landing on the other. Our baseline of a soft landing remains intact.

**Euro strength or dollar weakness?**

The EUR appreciating trend could come down to dollar weakness rather than euro strength. The dollar real effective exchange rate stands at record lows. Although the EURUSD estimated equilibrium exchange rate seems to have increased - we now estimate that it is around 1.25 - there is room for USD appreciation against the EUR as it is undervalued. The USD will thus mean-revert, but drawing from experience these trends take some time. The question is not if but when. A USD rebound is unlikely in the short-term as: 1) US external rebalancing is not yet taking place; 2) the trend in monetary policy actions is not expected to change in the near term; and 3) there are no clear signs of fiscal adjustment in the US. To sum up, in the mid-term the USD is bound to appreciate significantly against the EUR from current levels. However, in the absence of a clear trigger, our bias is for continued USD weakness in the short term. As soon as the gap in monetary policy paths narrows (possibly starting in 2Q12) the dollar will reverse its trend, albeit to levels a bit weaker than before as the fundamental value of the dollar has probably declined toward levels of 1.25.

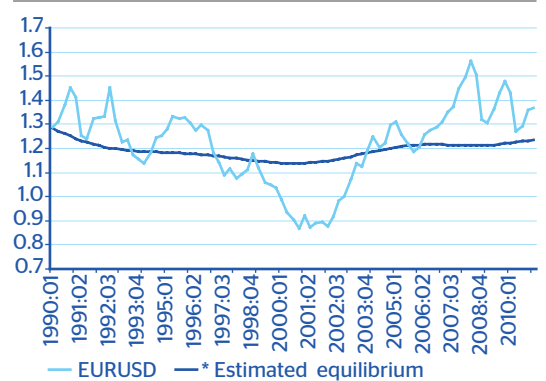
- Home →
- Markets →
- Calendar →
- Markets Data →

Chart 4  
**Chinese Manufacturing PMI**



Source: Bloomberg

Chart 5  
**Dollar-Euro and Estimated Equilibrium**



\* Dotted line is simple average of different models. Grey line is simple average of PPP and rest of models.  
Source: Bloomberg and BBVA Research

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## Calendar: Indicators

## Eurozone: Industrial production (March, May 13th)

Forecast: 0.5% m/m

Consensus: 0.8% m/m

Previous: 0.5% m/m

**Comment:** We expect industrial production to have increased further in March but at a slow pace, in line with April manufacturing surveys. Most national data will be released next week. These data are consistent with our projection of an activity rebound in Q1, supported by a faster recovery in the service sector, combined with a bounce back in the construction sector after Q4's weather-related slump. Looking forward, soft data also suggest that industrial recovery is likely to moderate in coming months, although domestic orders could take the lead complementing foreign demand. **Market Impact:** A very negative surprise could be interpreted by markets as more moderation in economic growth than anticipated.

## Eurozone: GDP (1Q10, May 13th)

Forecast: 0.6% q/q

Consensus: 0.6% q/q

Previous: 0.3% q/q

**Comment:** We expect the first estimate of National Accounts for Q1 to print quarterly GDP growth of 0.6% q/q. Available short-run data suggest that economic activity in the Eurozone has gained momentum at the beginning of 2011. We see a positive contribution from net exports in Q1. Regarding domestic demand, our forecasts suggest that private consumption will grow at a moderate pace, while public consumption could have stagnated, reflecting the implementation of fiscal austerity measures. In contrast, investment appears to have recovered after being affected adversely by weather conditions on its construction component. The breakdown by demand components will not be published in this flash estimate, however. We consider the risks to this forecast to be tilted to the upside, in particular due to stronger indicators published recently for Germany, which was affected by a severe winter at the end of 2010 and is expected to rebound. **Market impact:** Markets could react negatively to slower than expected economic growth in a context of still high uncertainty surrounding periphery countries.

## US: Retail Sales (April, April 12th)

Forecast: 0.8% m/m

Consensus: 0.6% m/m

Previous: 0.4% m/m

**Comment:** Consumer demand remained robust during the economic recovery despite weak labour market conditions. Retail sales have increased 0.8% m/m on average in the past nine months. However, a significant portion of the recent upward trend in retail sales is related with higher oil and consumer prices. We expect retail sales to increase 0.8% m/m, partially due to higher consumer prices. **Market impact:** If retail sales declines, it would indicate a sharp slowdown in personal consumption and bring stock markets down.

## US: Consumer Price Index, Core (April, April 13th)

Forecast: 0.5%, 0.2% m/m

Consensus: 0.4%, 0.2% m/m

Previous: 0.5%, 0.1% m/m

**Comment:** Consumer prices increased by 0.5% m/m in March on a seasonally-adjusted basis. Consumer price inflation was 1.1% m/m in November 2010 and the current inflation rate is at 2.7%, the second highest level since October 2008. The main drivers of the March increase were food and energy prices which accounted for roughly 75%. The energy index jumped 3.5% m/m, driven by the gasoline index which has increased 14.4% over the last three months. On the other hand, the pass-through effect from high oil and food prices to core prices remained limited. Core consumer prices, all items less food and energy, rose by just 0.1% m/m in March. We expect high energy and food prices to have continued to push consumer prices high but the pass-through effect on underlying prices remained limited in April. **Market impact:** A significant jump in core consumer prices could be a signal for high pass-through effect from high oil prices to core inflation and increase uncertainty and volatility in the financial markets.

Home



Markets



Highlights



Markets Data



## China: CPI for (April May 11th)

Forecast: 5.2% y/y

Consensus: 5.2% y/y

Previous: 5.4% y/y

**Comment:** Given risks of overheating, headline inflation will be closely watched, along with a batch of other monthly indicators for April including retail sales, fixed investment, industrial production, and credit growth. We expected inflation to ease in April due to a sharp decline in food prices from their high levels in March. Following a softer PMI reading for April, we also anticipate a moderation in accompanying activity indicators. **Market impact:** Sentiment will be easily swayed between concerns of overheating and more policy tightening on the one hand if inflation turns out higher-than-expected, and by risks of a hard landing on the other hand if the data are lower than expected.

## Markets Data

			Close	Weekly change	Monthly change	Annual change
Interest Rates (changes in bps)	US	3-month Libor rate	0.27	-1	-3	-16
		2-yr yield	0.60	0	-23	-21
		10-yr yield	3.22	-7	-33	-21
	EMU	3-month Euribor rate	1.42	3	15	74
		2-yr yield	1.79	1	-5	125
		10-yr yield	3.20	-4	-23	40
Exchange Rates (changes in %)	Europe	Dollar-Euro	1.452	-2.1	1.4	14.3
		Pound-Euro	0.88	-0.5	0.7	2.8
		Swiss Franc-Euro	1.27	-1.2	-3.5	-10.1
	America	Argentina (peso-dollar)	4.08	0.0	0.6	4.8
		Brazil (real-dollar)	1.61	2.1	-0.5	-12.4
		Colombia (peso-dollar)	1761	-0.5	-3.8	-12.8
		Chile (peso-dollar)	466	1.2	-1.6	-12.3
		Mexico (peso-dollar)	11.62	0.9	-1.5	-9.6
		Peru (Nuevo sol-dollar)	2.81	-0.6	-0.2	-1.6
		Japan (Yen-Dollar)	80.68	-0.7	-5.4	-12.0
	Asia	Korea (KRW-Dollar)	1078.25	1.0	-0.6	-6.5
		Australia (AUD-Dollar)	1.075	-1.8	3.2	21.2
Comm. (chg %)	Brent oil (\$/b)	110.3	-12.4	-9.8	40.9	
	Gold (\$/ounce)	1488.8	-4.8	2.0	23.2	
	Base metals	606.1	-2.2	-4.2	23.0	
Stock Markets (changes in %)	Euro	Ibex 35	10612	-2.5	-2.1	17.3
		EuroStoxx 50	2952	-2.0	-0.7	18.1
		USA (S&P 500)	1348	-1.2	0.9	21.3
	America	Argentina (Merval)	3306	-2.9	-5.7	53.0
		Brazil (Bovespa)	64173	-3.0	-7.0	2.1
		Colombia (IGBC)	13767	-4.3	-5.9	14.7
		Chile (IGPA)	22788	0.0	1.2	29.2
		Mexico (CPI)	35325	-4.4	-6.7	12.2
		Peru (General Lima)	20638	5.1	-4.2	39.0
		Venezuela (IBC)	75745	7.0	7.6	22.6
	Asia	Nikkei225	9859	0.1	2.9	-4.9
		HSI	23159	-2.4	-4.6	16.3
Credit (changes in bps)	Ind.	Itraxx Main	97	1	2	-34
		Itraxx Xover	357	5	-2	-240
	Sovereign risk	CDS Germany	39	-4	1	-16
		CDS Portugal	632	-21	79	210
		CDS Spain	236	-1	35	-2
		CDS USA	43	-2	6	---
		CDS Emerging	207	7	7	-87
		CDS Argentina	598	11	33	-429
		CDS Brazil	105	0	-2	-48
		CDS Colombia	100	0	-5	-82
		CDS Chile	59	-1	0	-36
		CDS Mexico	100	2	0	-52
		CDS Peru	142	-13	-8	-11

Source: Bloomberg and Datastream

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