BBVA Research

Global

Weekly Watch

Madrid, 8 April 2011

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

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

Markets

Highlights

Calendar

Markets Data

Central banks take centre stage

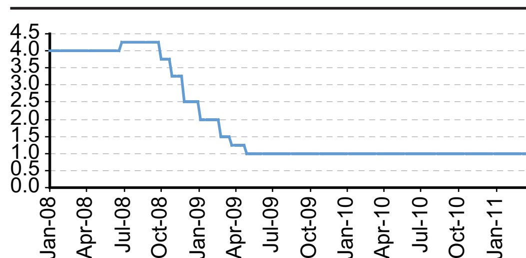
Throughout this week more clues have been revealed about how the ECB or the Federal Reserve will implement their monetary policy. On the one hand, the ECB hiked interest rates by 25bp, as expected. Although the ECB monetary policy statement was less hawkish, Mr. Trichet retained a tough tone and sent strong pre-emptive warnings about second-round effects. This suggests that the ECB does not see this rate increase as a pre-emptive move. We maintain our forecast of an additional 25bp hike in interest rates at the July meeting. After that, we think the ECB will be forced to adopt a wait-and-see approach until: i) uncertainties fade; ii) the European banks stress test results are released; iii) the liquidity problem is addressed; and iv) more clues about the impact of oil prices on the economy are available. On the other hand, the minutes of last month's US FOMC meeting confirm our baseline scenario that QE2 will be implemented as planned and that there will be no rate hike in 2011. Contrary to a more hawkish tone in some of the comments made by Federal Reserve officials, the minutes revealed that the majority of officials want to see QE2 through to the end. The FED signalled that the outlook for the economy is more balanced, and that inflation risks are tilted to the upside, although they consider oil price increases to be temporary. In our view, the degree of pass-through from energy to core inflation indices is a factor to monitor because it may hint on a change in the Federal Reserve's monetary policy stance. Additionally, China hiked interest rates by 25bp again, nearing the end of its tightening cycle. We anticipate one more rate hike in 2011 and a 100bp increase in the RRR. Peru also raised rates this week.

Portuguese bailout is not a significant event

Portugal's announcement to request a bailout was largely expected by market participants. Although we consider this decision to be a step to reduce market uncertainty, we do not expect Portugal's risk premium to narrow significantly. The details of the rescue still need to be defined. We expect the Portuguese bailout to amount to around EUR80bn and to be financed by a conditional loan from the EFSM/EFSF and IMF. The rescue package will concentrate more on structural reforms than on fiscal consolidation. A positive sign for the eurozone risk premium is that markets have still been differentiating between Spain and Portugal. Yesterday, although the ECB and the IMF supported the advances made by Spain in structural reforms, Spain must not hesitate in its effort to accelerate reforms. In our view, the European sovereign debt crisis is improving, but it has still not been completely resolved.

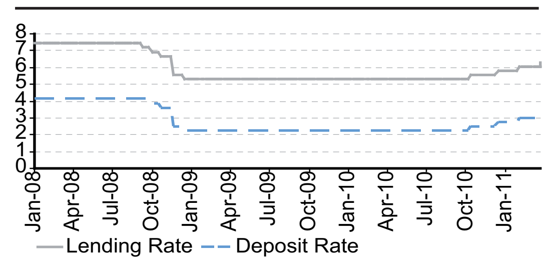
On the economic front, the most relevant issue is to what extent indicators are being affected by the impact of higher oil prices. Next week China will release important data such as inflation and new loans along with other indicators. In the US, March CPI and industrial production figures will be released.

Chart 1
ECB Rate



Source: Bloomberg

Chart 2
China Interest Rates



Source: Bloomberg

Highlights

Oil prices: one shock, but different outcomes in Brazil and Mexico

Mexico will enjoy a cyclical impulse from oil prices, while in Brazil the immediate impact is negative.

Growth spread between the US and the eurozone will widen…

… as oil and monetary policy restrictions will dent EMU growth.

Markets Analysis

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

Global Equity and Credit Strategy
Javier Requena
javier.requena@grupobbva.com
+34 91 537 83 99

Home
Highlights
Calendar
Markets Data

Markets

Another round of recapitalisation for European banks

During the last week, financial debt tightening was driven by two main reasons: i) the new round of recapitalisation for European banks. Commerzbank announced a EUR11bn recapitalisation and Intesa San Paolo also announced a EUR5bn capital raising. These capital increases are very positive from a credit point of view and should stand these entities in good stead to face the stress tests, and ii) the announcement by the Central Bank of Ireland that a haircut will not be applied to senior debt bondholders, at least not senior bondholders of Irish banks which were subjected to the Central Bank of Ireland's latest stress tests.

Muted market reaction to Portugal's request for aid

On top of Portugal's bailout, Fitch downgraded the rating of Portuguese covered bonds across the board. Generally speaking, the market's reaction to Portugal's decision to ask for financial assistance has been minimal and there has been virtually no contagion to Spain. Thus, Spain's 5Y CDS widened just 2bp after the bailout was announced and is at 203bp.

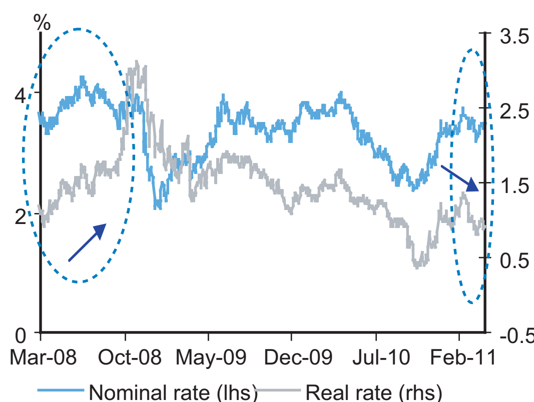
Breakevens in the US at all-time highs

The movement seen over the last week in the in the Treasury curve has been heavily influenced by the comments made by members of the Federal Reserve, which have been a mixture of hawkish and dovish messages. This highlights the discrepancies existing within the Federal Reserve when it comes to deciding the risk which inflation poses. In fact, in the minutes of the last meeting which were published this week, there was an increased reference to the recent rise in the breakeven rates. The latter are at the highest levels seen since 2008. However, the difference between now and 2008 is that now this movement is not just justified by the upward pressure of nominal rates, but also by the declining real rates (which have in fact corrected by almost 40bp since the end of February). This profile may be a reflection of the fact that: i) although the global risk premium has eased, there is still some demand for safe-haven assets; and ii) there is a certain degree of scepticism and uncertainty in the market surrounding the cyclical improvement in the US and whether this positive trend will continue once the current stimulus are withdrawn. We cannot rule out the possibility that the current factors will continue pushing up inflation expectations, especially as long as raw material prices continue generating volatility (Brent is at USD122/ barrel). Nevertheless, this movement should be limited in terms of nominal rates since they should continue to be anchored by real rates. In fact, to a certain extent, this is already happening; whilst the 2Y has reached February highs, the 10Y is still 20bp from its highs.

Carry Trade Environment Persists

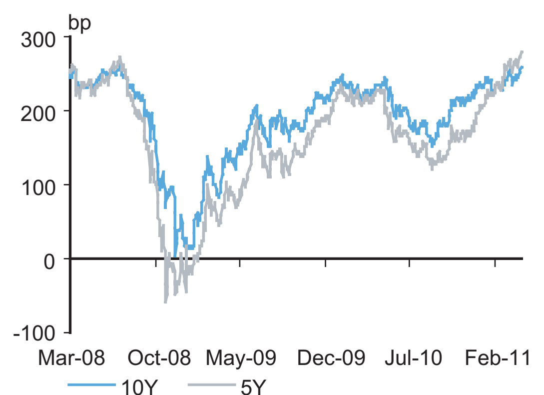
The USD continues to underperform most major currencies with only the JPY underperforming the USD over the last week. Indeed a pro-cyclical carry trade environment persists with high-yielding currencies such as the BRL and other commodity-related currencies outperforming. The threat of additional G7 intervention is enticing the FX market to short low-yielding currencies in favor of high-yielding currencies in order to pick up extra yield in what is seen by the market as an "almost riskless trade."

Chart 3
US Govt 10Y Nominal and Real Rates



Note: Out of TIPS
Source: Bloomberg and BBVA Research

Chart 4
US Treasury Breakevens



Note: Out of TIPS
Source: Bloomberg and BBVA Research

Economic Analysis

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

Brazil
Enestor Dos Santos
enestor.dossantos@grupobbva.com
+34 915376887

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

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

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

Highlights

Oil prices: one shock, but different outcomes in Brazil and Mexico

The impact of an oil price shock depends on oil's role in the economy in question, i.e. mainly whether the country is oil exporting or oil importing. Oil exporting countries benefit from a rainfall of foreign inflows from importing countries, but the final impact on their economies depends on specific factors such as: i) the distribution mechanism for the unexpected oil income (payment) between savings and expenditure; and ii) the possibility of cushioning the shock of costs for businesses and households.

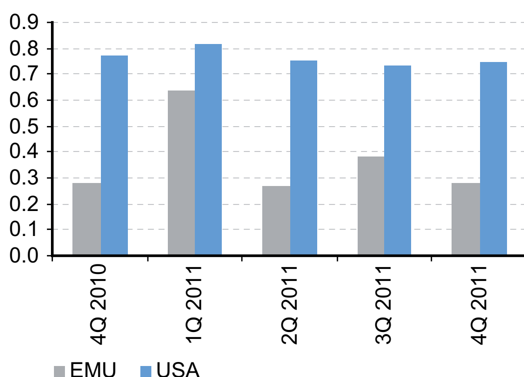
Mexico is an oil exporting country where oil extraction and distribution is a public monopoly. The Government obtains one third of its total income from oil and, in the case of unbudgeted revenue, only one third is saved in stabilization funds. Additionally, there is an implicit subsidy in the gasoline price that could lessen the impact of higher costs by close to 1% of Household income in 2011. As a result, it seems that Mexico will enjoy a cyclical impulse from oil prices added to the positive impact resulting from its close relationship with the growing US economy. Some upward pressure on inflation could limit real growth of disposable income, but subsidies and minor demand pressures limit price increases.

In Brazil, higher oil prices should ease the funding of pre-salt projects and therefore stimulate future oil production. However, the immediate impact of the oil shock is negative, especially because it fuels inflationary pressures. Higher oil prices along with a still too strong domestic demand are two of the reasons behind the higher than expected inflation over the last few months, which reached 6.3% y/y in March. Expectations for the end of 2011 jumped to around 6.0% y/y, well above the 4.5% y/y target. Although the Central Bank now seems to be more tolerant as regards inflation (which should imply some losses in terms of credibility), the implementation of some restrictive policies will limit GDP growth to at most 4% this year.

Growth spread between the US and the eurozone will widen

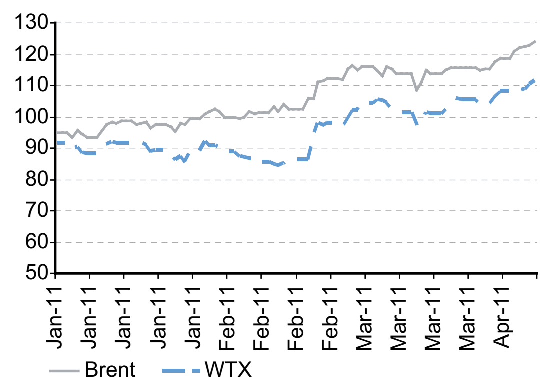
Confidence indicators deteriorated slightly in March, in both the US and the eurozone. This outcome suggests that the economic activity has peaked in 1Q in both areas after a higher than expected acceleration. Nevertheless, there is no evidence that neither eurozone nor US economy growth will face a strong slowdown in the coming quarter. However, both the increase in oil prices, due to the unrest in the MENA region, and the interest hike in the eurozone (we expect the ECB to increase interest rates by 50bp in 2011), amid the fiscal consolidation, will moderate the eurozone growth rate over the next few quarters, especially in the second half of the year. As a result, eurozone GDP will increase 1.7 percent in 2011, similar to the GDP growth registered in 2010. In the US, the impact of higher oil prices will offset the positive trends seen in employment and investment, preventing the economic activity from accelerating further and eliminating the upside risk to our forecast. Therefore, we expect US GDP growth rates over the next few quarters to remain similar to or slightly below those of 1Q11. For all of 2011 we maintain our forecast for US GDP growth at 3.0 percent. The combination of a slowdown in the eurozone's growth rate and stable US growth rates suggests that the GDP growth spread between the US and the eurozone will widen, especially in the second half of the year. This could further prevent Euro currency appreciation in terms of the US dollar.

Chart 5
GDP Growth quarterly ch.



Source: BBVA Research

Chart 6
Oil prices



Source: Bloomberg

Home
Markets
Calendar
Markets Data

Economic Analysis

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

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

Asia
Xia Le
xia.le@bbva.com.hk

Calendar: Indicators

Eurozone: Industrial production (February, April 13th)

Forecast: 0.7% m/m	**Consensus:** 0.7% m/m	**Previous:** 0.2% m/m

Comment: We expect industrial production to have increased further in February, as soft data up to March revealed a strong industrial sector at the beginning of the year. Most national data will be released next week, but strong German figures already published support our projection. Soft data also suggest that industrial recovery is likely to ease over the next few 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: HICP inflation (March, April 15th)

Forecast: 2.6% y/y	**Consensus:** 2.6% y/y	**Previous:** 2.4% y/y

Comment: We expect final HICP data to confirm that consumer inflation accelerated further in March, at a slightly faster rate than initially anticipated. Underlying this monthly increase are higher commodity prices, but also a slight acceleration in core inflation, due to the expected rebound in the prices of non-energy industrial goods after the end of winter sales. Processed food prices are likely to have increased further, while service inflation should have remained broadly stable. In particular, methodological changes on seasonal components could be pushing up core inflation. **Market impact:** A large surprise in core inflation could be interpreted as further evidence of indirect effects from rising commodity prices on higher and more persistent consumer inflation, fuelling fears of second-round effects over the next few months.

US: Consumer Price Index, core (March, April 15th)

Forecast: 0.5% m/m, 0.2% m/m	**Consensus:** 0.5% m/m, 0.2% m/m	**Previous:** 0.5% m/m, 0.2% m/m

Comment: In February, consumer prices surged mainly due to an increase in oil and food prices. The price index for energy commodities jumped 19.3% YoY, while the price index for energy services increased by just 0.2%. Increase in headline consumer prices was the largest monthly increase in headline prices since June 2009. Within core price indices, shelter prices are also no longer a drag to core inflation. They have increased by 0.1% MoM on average over the last five months. We believe that recent increases in oil prices are temporary and therefore pose no long-term threat to price stability, at least for the time being. We expect oil prices to carry on rising and continue to push headline inflation higher. However, the pass-through effect from higher energy prices to core prices will remain limited. **Market impact:** If consumer prices, particularly core prices, increase by more than the market expects, it would point to a higher pass-through from oil and food prices to underlying inflation and therefore could increase inflation expectations.

US: Industrial Production Index (March, April 15th)

Forecast: 0.7% m/m	**Consensus:** 0.5% m/m	**Previous:** 0.0% m/m

Comment: In the first two months of 2011, industrial production (IP) was slower than expected. Although regional manufacturing, ISM manufacturing and ISM services indices point to strong economic activity, the Federal Reserve announced that IP increased by 0.1% MoM on average over the last two months, compared to 0.6% on average in 2010. We expect IP to rise by around 0.7% MoM indicating robust economic activity in March, in line with other macroeconomic indicators. **Market impact:** If industrial production remains relatively stable in March, financial markets should question the sustainability and strength of the economic recovery. Equity markets would be negatively affected.

China: Real GDP Growth (2011Q1, April 15th)

Forecast: 9.3% y/y	**Consensus:** 9.3% y/y	**Previous:** 9.8% y/y

Comment: First quarter GDP will be watched for signs of a soft-landing following last year's rapid growth (10.3% for the full year). The GDP data will be released alongside a monthly batch of other indicators, including inflation and credit growth. We expect 1Q GDP to ease to 9.3% y/y, consistent with a slowing trend in retail sales and credit growth for January/February, and the authorities' recent monetary tightening measures, including another interest rate hike this Wednesday. **Market impact:** A stronger-than-expected reading could reignite concerns of more aggressive tightening measures, with adverse consequences for financial markets.

Home

Markets

Calendar

Markets Data

Markets Data

				Close	Weekly change	Monthly change	Annual change
Interest Rates	(changes in bps)	US	3-month Libor rate	0.29	-2	-2	-1
			2-yr yield	0.82	2	13	-23
			10-yr yield	3.59	15	12	-29
		EMU	3-month Euribor rate	1.29	4	12	65
			2-yr yield	1.90	8	17	93
			10-yr yield	3.48	11	19	32
Exchange Rates	(changes in %)	Europe	Dollar-Euro	1.444	1.6	3.8	7.2
			Pound-Euro	0.88	-0.2	2.6	0.5
			Swiss Franc-Euro	1.32	0.0	1.8	-8.4
		America	Argentina (peso-dollar)	4.05	-0.1	0.6	4.5
			Brazil (real-dollar)	1.58	-2.6	-4.7	-11.0
			Colombia (peso-dollar)	1816	-2.0	-3.2	-5.7
			Chile (peso-dollar)	470	-1.2	-1.7	-8.9
			Mexico (peso-dollar)	11.74	-0.8	-1.8	-3.7
			Peru (Nuevo sol-dollar)	2.77	-1.4	0.0	-2.5
		Asia	Japan (Yen-Dollar)	85.20	1.2	2.9	-8.6
			Korea (KRW-Dollar)	1082.65	-0.4	-3.1	-2.7
			Australia (AUD-Dollar)	1.054	1.6	4.4	13.0
Comm.	(chg %)		Brent oil ($/b)	124.5	4.9	7.4	46.8
			Gold ($/ounce)	1470.0	2.9	2.7	26.5
			Base metals	634.3	1.5	2.9	25.2
Stock Markets	(changes in %)	Euro	Ibex 35	10918	1.8	3.4	-4.2
			EuroStoxx 50	2986	0.8	1.7	-0.2
		America	USA (S&P 500)	1339	0.5	1.5	12.1
			Argentina (Merval)	3457	-0.4	0.0	38.9
			Brazil (Bovespa)	69139	-0.2	2.8	-3.2
			Colombia (IGBC)	14669	2.1	-3.4	18.6
			Chile (IGPA)	22359	0.6	5.3	24.6
			Mexico (CPI)	37472	-0.8	2.8	10.7
			Peru (General Lima)	21148	-1.9	-4.6	34.4
			Venezuela (IBC)	70366	0.1	4.1	17.1
		Asia	Nikkei225	9768	0.6	-7.8	-12.8
			HSI	24396	2.5	2.5	9.9
Credit	(changes in bps)	Ind.	Itraxx Main	96	-2	-5	17
			Itraxx Xover	363	-11	-23	-58
		Sovereign risk	CDS Germany	38	-6	-10	5
			CDS Portugal	549	-21	51	389
			CDS Spain	204	-14	-49	74
			CDS USA	40	0	-3	---
			CDS Emerging	196	-4	-10	-21
			CDS Argentina	562	-13	-29	-313
			CDS Brazil	107	-3	-3	-18
			CDS Colombia	104	-4	-8	-37
			CDS Chile	59	-4	-6	-26
			CDS Mexico	101	-2	-5	-13
			CDS Peru	132	-7	20	10

Source: Bloomberg and Datastream

DISCLAIMER

This document and the information, opinions, estimates and recommendations expressed herein, have been prepared by Banco Bilbao Vizcaya Argentaria, S.A. (hereinafter called "BBVA") to provide its customers with general information regarding the date of issue of the report and are subject to changes without prior notice. BBVA is not liable for giving notice of such changes or for updating the contents hereof.

This document and its contents do not constitute an offer, invitation or solicitation to purchase or subscribe to any securities or other instruments, or to undertake or divest investments. Neither shall this document nor its contents form the basis of any contract, commitment or decision of any kind.

Investors who have access to this document should be aware that the securities, instruments or investments to which it refers may not be appropriate for them due to their specific investment goals, financial positions or risk profiles, as these have not been taken into account to prepare this report. Therefore, investors should make their own investment decisions considering the said circumstances and obtaining such specialized advice as may be necessary. The contents of this document is based upon information available to the public that has been obtained from sources considered to be reliable. However, such information has not been independently verified by BBVA and therefore no warranty, either express or implicit, is given regarding its accuracy, integrity or correctness. BBVA accepts no liability of any type for any direct or indirect losses arising from the use of the document or its contents. Investors should note that the past performance of securities or instruments or the historical results of investments do not guarantee future performance.

The market prices of securities or instruments or the results of investments could fluctuate against the interests of investors. Investors should be aware that they could even face a loss of their investment. Transactions in futures, options and securities or high-yield securities can involve high risks and are not appropriate for every investor. Indeed, in the case of some investments, the potential losses may exceed the amount of initial investment and, in such circumstances, investors may be required to pay more money to support those losses. Thus, before undertaking any transaction with these instruments, investors should be aware of their operation, as well as the rights, liabilities and risks implied by the same and the underlying stocks. Investors should also be aware that secondary markets for the said instruments may be limited or even not exist.

BBVA or any of its affiliates, as well as their respective executives and employees, may have a position in any of the securities or instruments referred to, directly or indirectly, in this document, or in any other related thereto; they may trade for their own account or for third-party account in those securities, provide consulting or other services to the issuer of the aforementioned securities or instruments or to companies related thereto or to their shareholders, executives or employees, or may have interests or perform transactions in those securities or instruments or related investments before or after the publication of this report, to the extent permitted by the applicable law.

BBVA or any of its affiliates´ salespeople, traders, and other professionals may provide oral or written market commentary or trading strategies to its clients that reflect opinions that are contrary to the opinions expressed herein. Furthermore, BBVA or any of its affiliates' proprietary trading and investing businesses may make investment decisions that are inconsistent with the recommendations expressed herein. No part of this document may be (i) copied, photocopied or duplicated by any other form or means (ii) redistributed or (iii) quoted, without the prior written consent of BBVA. No part of this report may be copied, conveyed, distributed or furnished to any person or entity in any country (or persons or entities in the same) in which its distribution is prohibited by law. Failure to comply with these restrictions may breach the laws of the relevant jurisdiction.

In the United Kingdom, this document is directed only at persons who (i) have professional experience in matters relating to investments falling within article 19(5) of the financial services and markets act 2000 (financial promotion) order 2005 (as amended, the "financial promotion order"), (ii) are persons falling within article 49(2) (a) to (d) ("high net worth companies, unincorporated associations, etc.") Of the financial promotion order, or (iii) are persons to whom an invitation or inducement to engage in investment activity (within the meaning of section 21 of the financial services and markets act 2000) may otherwise lawfully be communicated (all such persons together being referred to as "relevant persons"). This document is directed only at relevant persons and must not be acted on or relied on by persons who are not relevant persons. Any investment or investment activity to which this document relates is available only to relevant persons and will be engaged in only with relevant persons.The remuneration system concerning the analyst/s author/s of this report is based on multiple criteria, including the revenues obtained by BBVA and, indirectly, the results of BBVA Group in the fiscal year, which, in turn, include the results generated by the investment banking business; nevertheless, they do not receive any remuneration based on revenues from any specific transaction in investment banking.

BBVA is not a member of the FINRA and is not subject to the rules of disclosure affecting such members.

"BBVA is subject to the BBVA Group Code of Conduct for Security Market Operations which, among other regulations, includes rules to prevent and avoid conflicts of interests with the ratings given, including information barriers. The BBVA Group Code of Conduct for Security Market Operations is available for reference at the following web site: www.bbva.com / Corporate Governance".

BBVA is a bank supervised by the Bank of Spain and by Spain's Stock Exchange Commission (CNMV), registered with the Bank of Spain with number 0182.