

# Weekly Watch

Global

Madrid, 8 July 2011  
**Economic Analysis**

*Financial Scenarios*  
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## Europe fails to reduce uncertainties

Financial strains in the European periphery have re-emerged once again. The Eurogroup failed to announce the expected second aid package for Greece last weekend, and the 12bn of the fifth tranche of the EU&IMF bailout will only cover Greek bond maturities for July and August. The resolution on a new package is still pending and, according to officials, conditional on "voluntary" private sector involvement. An additional source of uncertainty and volatility among European peripherals was brought by decisions made by rating agencies, in our view, the aggressive Portuguese downgrade by Moody's was not justified given the recent developments in the Portuguese economy. Uncertainty was also brought by the announcements by S&P and Fitch that the Greek sovereign rating could only be downgraded to selective default if the debt roll-over were to take place. Such a downgrade would have significant implications on eligible collateral for the ECB if the other two agencies, Moody's and BDRS, were also to downgrade Greece. The ECB has made its stance clear: "no selective default, no default, no credit event". However, the ECB will continue to accept Greek debt as long as at least one credit rating agency does not declare its debt as being in default. Furthermore, if such an event was to happen, the ECB may soften its stance and accept SD/D rated bonds or, alternatively, a new term lending facility could be implemented.

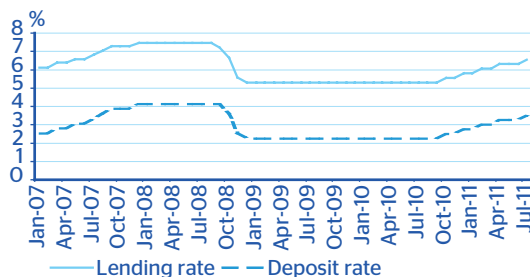
## US June employment report, a major disappointment

A bounce back in June's US employment was expected after the ADP report signalled much firmer private sector employment growth. However, payrolls rose by just 18K (well below the 110K consensus forecast) and job creation for the previous two months was revised down 44K. Data was weak across the board and there were no bright spots in the report. Needless to say this comes as a major disappointment, especially given that in the past two weeks US economic data was no longer consistently surprising on the downside. Elsewhere, in the EZ and China, economic indicators continue to point on balance to a slower pace of growth. Non-manufacturing indexes fell short of expectations in the main economic areas in June. Meanwhile, the ECB delivered the expected 25bp hike and retained a hawkish tone; an additional hike in 4Q is likely. China's central bank (PBoC) announced another interest rate hike; we expect one more rate hike during the remainder of the year given the still-strong underlying growth momentum.

**Next week** all eyes will be on China's 2Q GDP and June data to shed light on the pace of growth and inflation given concerns of inflation on one hand, and hard landing on the other. Attention will also be on June inflation in the US and EZ and Bernanke's semi-annual monetary policy report.

Chart 1

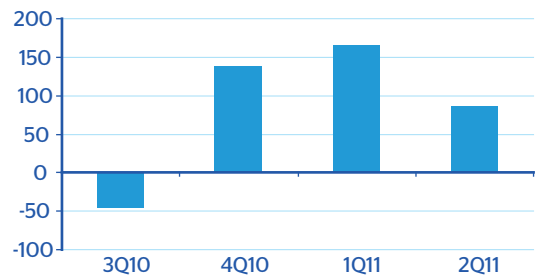
**China hikes rates again to tame inflation**



Source: Bloomberg and BBVA Research

Chart 2

**Weakness in US labour market\***



\* Job creation, monthly average  
 Source: Bloomberg and BBVA Research

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## Highlights

### Moody's downgrade of Portugal not justified by fundamentals

In our view, the revision is too aggressive and it is not justified by fundamentals.

### China: 2Q and June data to shed light on the pace of growth and inflation

Markets will be watching for further signs of a soft landing in the new data.

### Brazil: more FX measures are likely

In Brazil, focus on inflation does not mean that additional FX measures should be ruled out.

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**Slope decoupling in the US and Germany**

The correction of risk premiums following the approval of the Greek government's austerity plan is leading to a different profile in the euro and dollar curves. Both curves' movements are similar in terms of levels, however, there is decoupling as far as slopes are concerned. Whilst in Europe the sharpest reaction is being seen at the short end (up almost 30bp over the last week), increasing their sensitivity to ECB action, the same cannot be said for the Treasuries curve, as in the US expectations of a hike from the Fed have been put back until October 2012. The parallel movement between the two curves at the long end has led to a steepening of 15bp in the USA vs a flattening of 12bp in Europe. This decoupling between slopes should continue for as long as the bullish pressure brought by the easing of the risk premium is maintained on rates.

**Equity: key resistances could hold up short term**

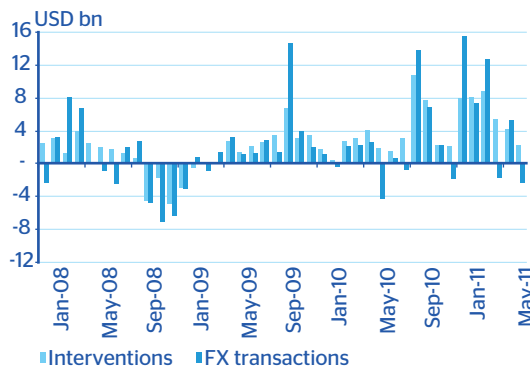
Although the current quarters could probably be the worst in a row for the US and Asian economies, this is not to say that doubts about a recovery in the second half of the year have disappeared: we should be aware of, firstly, the de-correlation between the S&P-500 and the US Consumer Confidence indexes and, secondly, the fact that consensus EPS for the S&P-500 has moved to negative territory in the very last few weeks. In Europe, we are still in the middle of the peripherals storm. The private banks involvement in the rescue of Greece is rumoured to be delayed until September, while Moody's downgrade of the Portuguese debt has caused a significant widening of both the Italian and the Spanish sovereign risk spreads. Moreover, it has triggered a significant surge of their respective 10Y IRRs, that are now challenging their key resistances at 5.2% and 5.7%, respectively. As a consequence, European Equity Risk Premiums have peaked again, although the V2X Index does not show significant downward risk short term. We guess there is plenty of value in European equities and that some relief for European equities is possible in the very short term: but any rebound will not be sustainable as long as the peripherals risk -and the global slowdown too- is a critical issue for financial markets.

**Brazil says currency war is not over yet**

BRL had a volatile session during last week. The currency reached a 2Y low on Monday because of a persistence of risk appetite recorded in the previous week. However, it depreciated sharply in Tuesday and Wednesday, responding to two main factors: 1) Portugal's debt downgrade and 2) amore interventionist language from both, the Ministry of Finance and the Central Bank. Regarding the latter, according to the FX weekly report, the CB bought only USD 0.3bn from June 27 to July 1 (during May and June average weekly USD purchases were 1.0bn and USD 0.5bn, respectively). It is worth mentioning during the same week, the balance of FX transactions was negative (-USD 1.0bn) while foreigners increased their long position in the BM&F by USD 1.4bn. We continue to believe if the CB decides to intervene more aggressively, especially while USDBRL is closer to 1.5500, that it is more likely to do so via derivatives markets and less so via more aggressive spot intervention. All things considered, we would expect the currency to consolidate within a range of 1.55-1.57 in coming days.

Chart 3

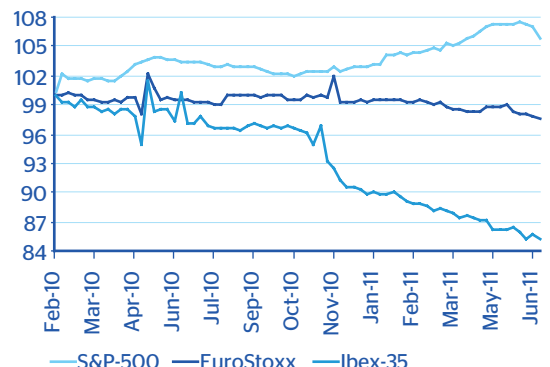
**FX inflows and interventions of the Central Bank in the spot market**



Source: BCB and BBVA Research

Chart 4

**EPS 2011 of the S&P-500, EuroStoxx and Ibex-35**



Source: Thomson Reuters and Bloomberg

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**Moody's downgrade of Portugal not justified by fundamentals**

Moody's has downgraded the rating of Portuguese debt by four notches to Ba2, below investment grade. The reasoning provided by the agency is related, first, to Portugal's possible need of a second rescue package, which would be accompanied by the involvement of the private sector (PSI), and second, to the risk that the measures in the Portuguese programme will take time to impact competitiveness and growth. In our view, the revision is too aggressive and is not justified by events which have taken place since the latest examination by Moody's (5 April). Then, Moody's focused its concerns on the political risk in Portugal, something which has mostly disappeared now, as Moody's recognises. The argument of a risk of restructuring and PSI was already considered in April, when Moody's explicitly acknowledged that the ESM included a clear possibility of PSI by 2013. Also, the fiscal and structural outlook in Portugal has not deteriorated since April, in fact, quite the opposite is true: a convincing IMF programme has been approved since then and the government has already taken measures to reduce the deficit. Moreover, it has also stated that it is ready to accelerate the implementation of these measures. It seems that Moody's is bringing its view more into line with the market's, which sees Portugal as a candidate for restructuring - extrapolating the analysis of Greece. Implicitly, Moody's is incorporating the recent handling of the Greek crisis on the EU side, especially concerning PSI. In our view, although the sovereign crisis management has been very poor, extending the Greek sequence of events to Portugal at such an early stage is not justified.

**China: 2Q and June data to shed light on the pace of growth and inflation**

Amidst the debate on whether its economy is over-heating or slowing too quickly, China is scheduled to release a stream of important economic indicators next week (which will be closely watched - see calendar). More specifically, the data will include 2Q GDP and foreign exchange reserves, along with June inflation figures, several activity indicators such as investment and trade and financial indicators. These indicators will be key inputs for authorities' fine-tuning of their macro policy stances and will be watched by markets for signals of future monetary policy tightening. We expect 2Q GDP to grow by 9.5% y/y, in line with a gradual slowdown from the 9.7% growth in 1Q (see indicator of the week for details). The latest PMI figure which was released earlier this week, and which has declined for a third consecutive month, supports the likelihood of a slowdown. The moderation for June was larger than expected and across the board, with production, employment, purchases for input materials, and new orders all falling. Despite the slowing PMI, the central bank raised interest rates again this last week (6 July), for the fifth time since last October, seeking to rein in inflation. We expect June inflation to peak at 6.1% y/y from 5.5% in May, before declining during the remainder of the year. Our baseline scenario is for one more rate hike and one more hike in the required reserve ratio during the remainder of the year, in contrast to many analysts who believe that the central bank may have finished raising interest rates in view of weaker growth indicators.

**Brazil: more FX measures are likely**

In Brazil, the focus on inflation does not mean that additional FX measures should be ruled out, despite the recent moderation, inflation in Brazil reached 6.7%y/y in June, higher than the 6.5% inflation target's upper-bound and high above the 4.5% central target for the end of the year. The Central Bank will therefore be forced to implement one or two extra upward adjustments of the SELIC, which was already brought up to 12.25% (+150bp) in the first half of the year. We don't expect concerns regarding the appreciation of the exchange rate to prevent the SELIC from moving up. Even though monetary policy will remain focused on bringing inflation down, more FX measures are expected to be announced to avoid the real appreciating more sharply, especially if the Brazilian currency trades below the 1.55 mark.

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Calendar: Indicators

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Eurozone: industrial production (May, 13 July)

Forecast: 0.1% m/m	Consensus: : 0.4% m/m	Previous: 0.4% m/m
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**Comment:** We expect industrial production to have virtually stagnated in June, after the modest increase observed in the previous month. This would imply that the industrial sector has lost steam in the second quarter, in line with signs from soft data available for 2Q and somewhat expected after the upbeat momentum observed over the last year. Nevertheless, the industrial recovery should proceed at a slower pace over the coming months, as demand from emerging economies should continue to be supportive, especially in equipment and intermediate goods. Overall, available data provides further evidence that the cyclical peak has already been reached. **Market impact:** a very negative surprise could be interpreted by markets as a sharper than anticipated easing in economic growth.

Eurozone: final HICP inflation (June, 14 July)

Forecast: 2.7% y/y	Consensus: 2.7% y/y	Previous: 2.7% y/y
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**Comment:** We expect headline inflation to be confirmed at 2.7% y/y in June, remaining unchanged from the previous month, slightly below previous expectations of a timid acceleration. Recent easing in oil prices may be behind June's stabilisation, although it could also be due to a slower acceleration in core inflation. Nevertheless, we think that a stabilisation in inflation may be short-lived, and that it could increase slightly in September to a rate of close to 3%, before easing once again. In addition, core inflation is likely to increase further in coming months to around 2% by year end. **Market impact:** a further acceleration in core inflation could heighten market concerns about higher indirect effects that could result in a tighter monetary policy in order to avoid both second-round effects and the de-anchoring of inflation expectations.

US: Retail Sales (June, 14 July)

Forecast: 0.1%	Consensus: 0.0%	Previous: -0.2%
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**Comment:** the automotive industry weighed down retail sales, which declined 0.2% MoM in May. Lingering effects of the Japanese earthquake impacted automotive supplies and prices, ultimately suppressing May's automotive demand. However, price impacts are expected to fade as supply chains normalise throughout the summer, which should boost headline retail sales. Data suggest that consumers were relatively unshaken by the previous run-up in commodity prices; therefore, as automotive sales increase, we expect retail sales to improve on last month's numbers. **Market impact:** positive job market data and manufacturing production suggest that the recent slowdown may be fleeting, increases in June retail sales would help strengthen positive market expectations.

US: Consumer Price Index, core (June, 15 July)

Forecast: 0.0%, 0.2%	Consensus: -0.1%, 0.2%	Previous: 0.2%, 0.3%
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**Comment:** core consumer prices jumped in May while headline consumers prices eased to an annualised rate of 2.0%. Accelerating commodity prices were expected to impact headline inflation throughout the summer, yet sharp declines in both energy commodity and gasoline prices pushed down headline inflation in May. Core inflation, however, increased by 0.3% MoM. The increase is a 2 year high, but given that the major contributors to last month's increase - apparel, shelter and autos - appear to be temporary, there is little concern for sustained acceleration. **Market impact:** the Fed is keeping a close watch on core prices, so any significant MoM jumps or a continuation of core consumer price growth above 0.2% MoM will cause the Fed to revisit its current rate target.

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China: 2Q GDP (15 July)

Forecast: 9.5% y/y	Consensus: 9.3% y/y	Previous: 9.7% y/y
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**Comment:** the 2Q GDP outturn will be closely watched for signs of a "soft-landing", along with a batch of accompanying monthly activity indicators and inflation for June. The authorities have continued to tighten monetary policy to slow credit growth and rein in inflation, including another rate hike this last week (the fifth since October). We expect 2Q GDP to ease, based on the fact that recent high frequency indicators have been showing a healthy slowdown. **Market impact:** a weaker-than-expected reading could aggravate market fears of a "hard-landing", while a stronger-than-expected outturn could raise expectations of further monetary tightening.

## 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	0	-28
		2-yr yield	0.38	-9	0	-24
		10-yr yield	3.03	-16	9	-3
	<b>EMU</b>	3-month Euribor rate	1.59	4	14	77
		2-yr yield	1.46	-19	-20	69
		10-yr yield	2.84	-19	-21	21
<b>Exchange Rates</b> (changes in %)	<b>Europe</b>	Dollar-Euro	1.429	-1.6	-2.2	13.0
		Pound-Euro	0.89	-1.4	-0.1	6.0
		Swiss Franc-Euro	1.20	-2.9	-2.0	-10.7
	<b>America</b>	Argentina (peso-dollar)	4.12	0.3	0.8	4.7
		Brazil (real-dollar)	1.56	0.6	-1.1	-11.0
		Colombia (peso-dollar)	1759	-0.1	-0.8	-6.2
		Chile (peso-dollar)	463	-0.5	-1.0	-14.1
		Mexico (peso-dollar)	11.62	-0.1	-1.4	-9.1
		Peru (Nuevo sol-dollar)	2.75	0.0	-1.0	-2.7
		Japan (Yen-Dollar)	80.62	-0.3	1.0	-8.9
	<b>Asia</b>	Korea (KRW-Dollar)	1057.49	-0.8	-2.2	-11.8
		Australia (AUD-Dollar)	1.072	-0.4	0.6	22.4
<b>Comm.</b> (chg %)	Brent oil (\$/b)	117.6	5.2	-0.2	55.9	
	Gold (\$/ounce)	1541.9	3.6	0.3	27.3	
	Base metals	603.5	0.5	-0.2	27.5	
<b>Stock Markets</b> (changes in %)	<b>Euro</b>	Ibex 35	9971	-5.0	-1.1	-1.5
		EuroStoxx 50	2800	-2.6	1.8	4.4
		USA (S&P 500)	1337	-0.2	4.5	24.0
	<b>America</b>	Argentina (Merval)	3480	2.5	11.4	52.0
		Brazil (Bovespa)	61453	-3.1	-2.5	-3.2
		Colombia (IGBC)	13811	-1.9	-4.3	10.1
		Chile (IGPA)	22484	-0.9	-1.2	16.2
		Mexico (CPI)	36378	-1.1	4.3	13.7
		Peru (General Lima)	19825	3.2	-3.7	41.8
		Venezuela (IBC)	81295	1.0	1.0	24.0
	<b>Asia</b>	Nikkei225	10138	2.7	7.3	5.8
		HSI	22726	1.5	0.3	11.5
<b>Credit</b> (changes in bps)	<b>Ind.</b>	Itraxx Main	109	6	3	-6
		Itraxx Xover	409	25	17	-120
	<b>Sovereign risk</b>	CDS Germany	43	2	5	2
		CDS Portugal	984	248	275	706
		CDS Spain	302	34	48	89
		CDS USA	52	2	3	--
		CDS Emerging	206	2	-14	-40
		CDS Argentina	594	16	-23	-312
		CDS Brazil	107	-2	-4	-22
		CDS Colombia	105	-3	1	-35
		CDS Chile	74	-1	3	-21
		CDS Mexico	106	-2	-1	-22
		CDS Peru	126	-6	-26	0

Source: Bloomberg and Datastream

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