

# Weekly Watch

Global

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**Economic Analysis**

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## Greece weighs on global risk premium

Risk aversion continues to affect global financial markets, in spite of better-than-expected economic data in the USA and China. The main factors behind the increase in the global risk premium relate to the Greek aid package; particularly to the time that it will take to deliver, and whether private-investment involvement will be required. The European Commissioner for Economic and Financial Affairs announced last Thursday that he wants an agreement on additional financial aid to Greece achieved by July 11, two weeks after the previously expected deadline (June 24), and 4 days before the €2.4bn debt repayment that Greece has to make. But to provide additional support to Greece, the EU and the IMF want Greece to commit to the austerity program. Thus it will also be crucial that the Greek Prime Minister Mr Papandreou wins the confidence vote this Sunday, so that the Greek Parliament is able to pass the austerity measures at the end of June. On the other hand, the upcoming meetings of EU leaders will bring an opportunity to get an agreement on private-investors involvement, although comments from EU ministers after the last ECOFIN meeting suggested that any private bail-out must be voluntary, in line with the ECB position (see highlight). All of this suggests that financial strain will remain high in the coming days.

### Inflation prompts more tightening

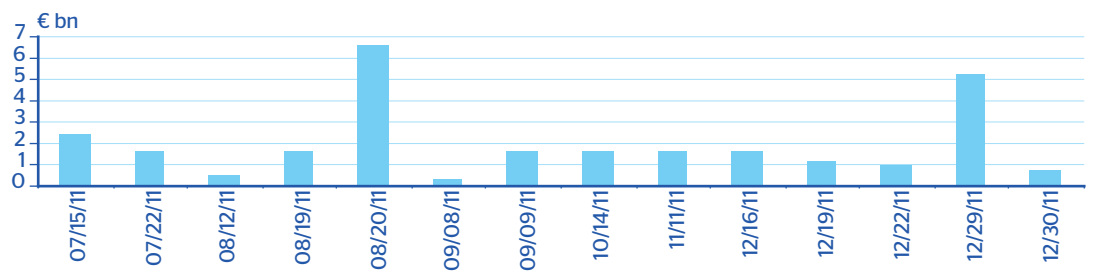
Although last week some Asian Central banks moderated their bias on inflation, citing concerns on global growth, this week both China and India continued their monetary tightening in order to fight against the ongoing inflation pressures (see highlight). Meanwhile the Central Banks of Brazil, Chile and Colombia hiked rates 25bp but they have left the door open to a pause in their interest rate normalization process if the global deterioration deepens.

**Next week** the Federal Reserve holds a two-day meeting. We expect its monetary policy to remain unchanged. This week's economic data suggested that the US economy is facing a soft patch phase rather than a double-dip, while core inflation rose 0.3% m/m in May to levels not seen since July 2008. This has been driven by price increases in apparel, shelter, new vehicles, and recreation. But the Fed will wait until indicators show clear evidence that the US economic growth is self-sustainable.

**In the EMU** investors will be focused on the conclusion of the EU Council meeting. Additionally, the EZ June PMI will give investors some clues about the degree of the cyclical slowdown in the area.

Table 1

**Greece: Public debt repayment**



Source: BBVA Research

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## Highlights

### Greece: Same road, but much noisier than expected

The most probable scenario is still minimal private sector involvement - but with delays to key decisions.

### TARGET2: the other side of the (ECB liquidity) coin

It does not increase the monetary base or generate any new risk.

### China: rising inflation brings more monetary tightening

Activity indicators show a healthy moderating trend, while inflation remains high.

## Markets Analysis

## Markets

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+34 91 537 83 99*Global FX**Chief Strategist***Dustin T. Reid**Dustin.Reid@bbvany.com  
+1 (212) 7281707**Greece's risk premium rockets**

In general, OECD curves have been undergoing additional corrections, as the risk from Greece has led to growing nervousness on markets. The latest driver was the Greek prime minister's offer to resign, which triggered a new risk premium shock, but was later rejected. Not only are euro rates already at lower levels than during the Japanese crisis at the short end, and below January levels at the long end, we are also starting to see some knock-on effects on parts of the market which were previously less affected. For example, asset swaps have a slightly more upward bias, reflecting greater sensitivity to financial risk and the implications for the liquidity market in the short term. In fact, the curves for USD Euribor and Libor futures tightened for the earliest expiries (5bp up in recent days, while the latest have corrected downward). This trend has previously been seen when there was credit event risk on other occasions.

**The supports are holding up, but the pressure remains**

The rally we anticipated last week, led by the financial and cyclical sectors lasted a day and a half. Major discrepancies at the heart of the EMU - in one camp Germany, and in the other the ECB and France - with regard to the second bailout of Greece, together with the more or less persistent slowdown reflected in US and Asian macro data have led to greater pressure on the euro and fresh falls on equity markets. These drops have also occurred at a time of high correlation between sectors and an increase in volatility, with the VIX and V2X breaking above critical resistances. In addition, as we mentioned last week, increased European sovereign risk would result in flows favouring a return to the negative correlation between the dollar and the EuroStoxx/S&P-500 relative. The problem is that the underlying trends, in macro terms and in terms of Greece, will persist, at least in the short term. This is not good news for financial markets, above all Europe. On the positive side, traded volumes are declining as equity markets correct, favouring the leaders, the S&P-500 and the Shanghai Composite, maintaining their key medium-term supports at approximately 1.250 and 2.670, respectively.

**Greek Debt Issue Key Driver for FX**

FX markets continue to watch the Greek peripheral debt issue with angst. The news flow appears to be changing on an almost daily basis, underscoring our view of generally higher FX vols across the board and specifically in EURUSD and EUR crosses. The most important announcement during the most recent week was Luxembourg's Finance Minister suggesting late Tuesday afternoon a decision regarding another Greek bailout previously expected at or on 20 June would be delayed. The result was a circa 2% decline in EURUSD Wednesday with the pair posting its worst performance since August 2010. During the rout, the USD was very well bid with the USD-index also experiencing its best day since August 2010. As EUR positioning has backed off its record highs, we believe the Greek situation coupled with the US economic data flow will be the key themes to watch in the coming weeks.

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**Greece: Same road, but much noisier than expected**

This week two main events have affected the prospects of resolution of the Greek crisis, amid increased volatility in sovereign markets. On the one hand, the Greek prime minister has changed the minister of finance (Mr Venizelos will substitute Mr Papaconstantinu) in order to revive the push for fiscal reforms, and after an offer of a coalition government was rejected by the opposition (who oppose the current austerity measures and want new elections). The crucial vote on the fiscal reforms will take place around June 30, and there is still internal opposition from the governing party to new measures, although the most probable scenario is that they will be approved. On the other hand, there are likely to be delays to the new package of fresh money that the troika will concede to Greece to cover its financial needs as from 2012. Until now it was expected that this would be approved at the EU summit on 23-24 June, since ensuring future financing was a requirement by the IMF to disburse the pending tranche of the current loan, which is needed by Greece before mid-July to avoid default. Now the IMF seems to have dropped such a requirement, and the debate on the new package has been postponed to July 11, or even later. The crucial point of the involvement of the private sector in the new package has to be resolved within that debate. Between the two likely options - the German one of a debt swap extending maturities, and the ECB one of purely voluntary rollover of current debt- the most likely one at this point is the latter, but it is far from sure. All in all, the most probable scenario remains unchanged - a new package for Greece, minimal involvement of the private sector - but with delays to the key decisions and with much more noise than necessary, which is being reflected in spreads throughout the region.

**TARGET2: the other side of the (ECB liquidity) coin**

TARGET2 balances arise from the cross-border distribution of central bank money within the decentralized structure of the euro system. These accounts are intra-system positions, reflecting movements in the balance of payments. They are debts between National Central Banks (NCBs) that are aggregated across the eurozone by TARGET2 (the EU gross settlement system). The balance is not reported on the ECB's balance sheet, since it is zero in the aggregate, but it does show up on the respective balance sheets of the NCBs as interest-bearing claims against, and liabilities to the ECB system. Until mid-2007, the Target accounts were very small, but since then they have grown until the end of 2010. Total Eurosystem TARGET2 claims at the end of 2010 were €457.1bn while in 2005 they were €71bn. According to the latest data, the Bundesbank is supporting most of the lending (€325.7bn: 70%) while the Central Bank of Ireland (CBI) is the biggest borrower (around €150bn), followed by the NCBs of Greece and Portugal (€87bn and €61bn, respectively). These balances do not affect the amount of monetary base available because for a given monetary base growth, the distribution of liquidity is a result of the ECB still providing liquidity at a fixed rate and on a full allotment basis. In terms of risks, the size and distribution of the target accounts across the Eurosystem central banks are, however, irrelevant to their risk exposure by the provision of funds from the Eurosystem. For that reason, this does not create any new risk not already contained in monetary policy refinancing operations; therefore, no matter which NCBs executes the Eurosystem refinancing operation, any losses would be shared among the NCBs of the Eurosystem.

**China: rising inflation brings more monetary tightening**

The People's Bank of China (PBoC) earlier this week announced another 50bp hike in the required reserve ratio (RRR), effective from June 20. It marks the sixth hike in the RRR this year on top of two previous 25bp hikes, and is expected to withdraw around RMB 390 billion in liquidity. The move brings the RRR for large banks to a new record of 21.5%. The hike in the RRR came on the heels of the release of the latest batch of monthly economic indicators, for May. Robust outturns for industrial production, retail sales and urban fixed investment all helped to allay concerns of a hard-landing. However, headline inflation in May climbed to 5.5% y/y, the highest figure since August 2008, driven by both food and non-food components. The outturn was in line with expectations, but well above the authorities' 4% comfort range. We expect inflation to peak in June at around 6%, before declining during the second half of the year. Given ongoing inflation risks, we expect the authorities' gradual monetary tightening to continue, with two more rate hikes in Q2/Q3, and at least another 50bp increases in the RRR.

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Calendar: Indicators

**Eurozone: Flash PMI composite (June, June 23rd)**

<b>Forecast: 54.8</b>	<b>Consensus: 55.2</b>	<b>Previous: 55.8</b>
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**Comment:** we expect the composite PMI to decline further in June, especially in the manufacturing sector, while confidence in services should remain more resilient. The average composite PMI for Q2 should have remained in expansionary territory, but clearly below Q1's level, closer to those observed in the second half of last year when GDP grew by around 0.3%-0.4% q/q. This declining trend is expected to be observed across member states, although the divergence between the core and the periphery will continue. **Market Impact:** a very negative surprise could be interpreted by markets as more moderation in economic growth than anticipated.

**Germany: Retail sales (May, June 24th)**

<b>Forecast: 0.6% m/m</b>	<b>Consensus: 1.0% m/m</b>	<b>Previous: 0.6% m/m</b>
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**Comment:** German retail sales are likely to have increased further in May, as observed in the previous month, although at a more moderate pace than in Q1. These figures should continue showing very subdued household spending in the current quarter, suggesting that private consumption could decelerate somewhat in Q2, after growing at a good pace in previous quarters. Nevertheless, the drivers underlying household consumption have been building up over past quarters and are still there. **Market impact:** a sharp drop in retail sales could raise doubts about the sustainability of the recovery in domestic demand, returning to a pattern of growth which is more dependent on the evolution of external demand.

**US: FOMC Rate Decision (May, June 22th)**

<b>Forecast: 0.0%-0.25%</b>	<b>Consensus: 0.0%-0.25%</b>	<b>Previous: 0.0%-0.25%</b>
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**Comment:** a decelerating economy and rising prices might create a policy dilemma if sustained for long periods. However, the Fed believes that the recent increase in inflation is temporary and the pass-through effect to underlying prices will be limited. The latest CPI release showed that headline inflation rose 0.2% MoM in May, the lowest level of 2011, while core inflation was unexpectedly high at 0.3% MoM. We expect the Fed to continue to monitor core inflation in 2H11. Moreover, after the recent slowdown, the Fed is more concerned with economic sustainability rather than inflation. Therefore, we expect no change to the current Fed Funds rate of 0% - 0.25%. **Market Impact:** the probability of interest rate hikes is extremely small, therefore we expect little market activity following Wednesday's meeting. If there are any significant changes in the statement, equity and fixed income markets will be immediately affected.

**US: Durable Goods Orders (May, June 24th)**

<b>Forecast: 1.1% m/m</b>	<b>Consensus: 1.6% m/m</b>	<b>Previous: -3.6% m/m</b>
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**Comment:** durable goods orders declined in April 3.6% MoM, on a seasonally-adjusted basis, after a large jump in March (4.6% MoM). Most of the industries saw declines in new orders but the main driver of this drop was transportation equipment, which had the largest decrease in the last four months, at 9.3%. We expect economic activity to increase in 2Q11, which should positively impact durable goods orders in May. **Market Impact:** if durable goods orders surpass consensus estimates, it would suggest stronger future economic activity and, therefore, equity markets will react favorably.

**Japan export growth in May (June 20th)**

<b>Forecast: 1.3% y/y</b>	<b>Consensus: -8.4 % y/y</b>	<b>Previous: -12.4% y/y</b>
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**Comment:** after a series of disappointing production and activity indicators in March and April, it appears that a strong rebound is underway as disruptions to supply chains, especially in the auto sector, are diminishing. As a result, May exports should begin to show some growth. **Market impact:** a higher-than-expected outturn would lift confidence in Japan's recovery and growth outlook.

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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	0.37	-3	-18	-34
		10-yr yield	2.93	-4	-25	-29
	<b>EMU</b>	3-month Euribor rate	1.50	3	7	77
		2-yr yield	1.51	-3	-31	93
		10-yr yield	2.96	0	-16	23
<b>Exchange Rates</b> (changes in %)	<b>Europe</b>	Dollar-Euro	1.429	-0.6	0.2	15.6
		Pound-Euro	0.88	0.0	0.3	5.9
		Swiss Franc-Euro	1.21	0.1	-3.5	-11.8
	<b>America</b>	Argentina (peso-dollar)	4.10	0.1	0.2	4.3
		Brazil (real-dollar)	1.60	0.1	-0.8	-9.8
		Colombia (peso-dollar)	1788	0.7	-2.0	-6.4
		Chile (peso-dollar)	472	0.9	0.4	-11.8
		Mexico (peso-dollar)	11.92	0.5	1.7	-4.9
		Peru (Nuevo sol-dollar)	2.76	-0.2	0.3	-2.4
		Japan (Yen-Dollar)	80.16	-0.1	-1.6	-11.6
	<b>Asia</b>	Korea (KRW-Dollar)	1087.95	0.4	0.0	-9.5
		Australia (AUD-Dollar)	1.060	0.4	-0.1	22.0
<b>Comm.</b> (chg %)	Brent oil (\$/b)	112.9	-5.0	0.5	44.3	
	Gold (\$/ounce)	1535.1	0.2	2.5	22.1	
	Base metals	602.8	-0.6	-0.4	26.5	
<b>Stock Markets</b> (changes in %)	<b>Euro</b>	Ibex 35	10135	1.9	-2.0	1.6
		EuroStoxx 50	2770	1.4	-3.4	1.2
		USA (S&P 500)	1271	0.0	-5.2	13.8
	<b>America</b>	Argentina (Merval)	3253	0.8	-4.0	40.2
		Brazil (Bovespa)	60714	-3.2	-3.4	-5.8
		Colombia (IGBC)	14085	-2.2	-0.9	12.7
		Chile (IGPA)	21752	-3.2	-5.4	14.2
		Mexico (CPI)	35265	0.9	-0.3	7.5
		Peru (General Lima)	19909	-3.6	-9.8	38.8
		Venezuela (IBC)	80813	-0.3	3.4	24.1
	<b>Asia</b>	Nikkei225	9351	-1.7	-3.2	-6.4
		HSI	21695	-3.2	-5.7	6.9
<b>Credit</b> (changes in bps)	<b>Ind.</b>	Itraxx Main	113	4	15	-4
		Itraxx Xover	417	17	60	-103
	<b>Sovereign risk</b>	CDS Germany	43	2	4	4
		CDS Portugal	809	71	194	520
		CDS Spain	300	27	59	89
		CDS USA	52	1	5	--
		CDS Emerging	232	10	28	-20
		CDS Argentina	629	32	33	-366
		CDS Brazil	116	4	16	-11
		CDS Colombia	110	4	12	-37
		CDS Chile	75	3	12	-19
		CDS Mexico	112	4	14	-13
		CDS Peru	151	7	20	27

Source: Bloomberg and Datastream

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