BBVA RESEARCH

Weekly Watch
Global

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Economic Analysis

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Calendar

Markets Data

Excess debt at center stage

Uncertainties regarding public debt have returned to the center stage. This week was a reminder of some of the risks that the world economy faces and policymakers must address: fiscal deficits remain too large, consolidation has not begun in the US, while solvency problems are back within the eurozone.

In Europe, Greek debt restructuring concerns caused contagion across the board, but markets have since begun to correct losses felt earlier this week. It was expected that this issue would appear at some point because, as we have already mentioned, these problems had not been resolved in a satisfactory manner. In the US, the fiscal debate continues as S&P revised its outlook of the US's credit rating to negative on Monday on concerns on how the US will address its "very large budget deficits and rising government indebtedness." S&P's revision rattled market confidence, but the effects have since proven to be transitory and investors' risk appetite has returned. Noise surrounding US debt ceiling negotiations will most likely continue. But what is more relevant is that the US economy advances towards fiscal consolidation in the medium term. Yet, what seems clear is that the world economy still faces plenty of risks and thus, is not on a stable path.

On the macro front, the limited data released did not alter our forecast of slowing growth in developed economies. Next week, markets will be focused on the Fed's rate decision and press conference taking place on Wednesday.

Highlights

The Reversal of Extraordinary Monetary Policies

Our expected path for the Fed's reversal of policies is directly based on BBVA's baseline scenario for GDP and inflation a gradual increase inflation while the modest economic growth will continue through 2011. In our view each stage of the sequence will require communication from the Fed to ensuring clarity of objectives. We expect the Fed to finish the LSAP at the end of June 2011, with no need for another round of purchases. The second step is to halt the reinvestment of principal from maturing balance sheet MBS, likely to be announced either in August or September. In the third stage the Fed will wish to normalize the balance sheet while at the same time raising interest rates. Given liquidity trap conditions, the corridor system is the only viable way to increase the Fed Funds rate away from zero. We expect the first increase rates to occur in March 2012, although there are moderate risks of an earlier hike. In order to prepare for the first use of the corridor system, the Fed will remove the reference to "exceptionally low levels for the federal funds rate for an extended period" two months prior to the March rate hike. Sales of securities on the Fed's balance sheet may occur before, during or after the use of the corridor, as market conditions allow. Lastly, the Fed will begin to sell its stock of MBS, but this could occur earlier if the Fed perceives a high level of demand. For further information, see our FedWatch.

Markets

Implications of the downgraded outlook for US debt and the debate on the budget in Congress

The increase in US debt (relative to GDP) and the lack of political consensus over the budget and the cap on debt have led S&P to downgrade its outlook for US debt to "negative". The repercussions of this on markets in recent weeks have mainly been reflected in two ways: i) upward pressure on the 2/10 Govt swap, since the long ends of curves are more sensitive to fiscal risk; ii) Narrowing of asset swaps. The relationship between Asset Swaps and the budget deficit is direct: during periods with negative output gaps the state's tax revenues are low and it must increase debt by issuing more bonds, which pushes up Govt rates vs. Swap rates (Asset Swaps decline). During expansive cycles the state issues less debt (reducing the deficit) and Govt rates drop vs. Swap rates, pushing up Asset Swaps. Going forward, in the coming months the slope will depend to a greater degree on the short end of the curve, since it will start to discount Fed rate hikes, leading to a bias towards flattening. In addition, Asset Swaps will remain tied to the budget deficit, which may even mean, depending on the outcome of the debate in congress, that they return to negative territory (in the case of the 10Y).

Economic Analysis

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Calendar: Indicators

Eurozone: M3 (March, April 29th)

Forecast: 1.8% y/y	Consensus: n.a.	Previous: 2.0% y/y

Comment: Eurozone lending data for March are expected to reflect a still sluggish credit performance. M3 is projected to keep growing in March although at a slower pace, after the surprise registered in February that showed further evidence of credit recovery, albeit still modest. Across its counterparts, loans to households are expected to have increased further, accelerating from growth rates observed over the last year. Nevertheless, loans to non-financial corporations will slowdown its pace of growth, after the rebound observed in January and February. **Market impact:** Better than expected outcomes could be received as a sign that credit is recovering, but also can be read as a trigger for a tighter stance by the ECB.

Eurozone: HICP inflation (April, April 29th)

Forecast: 2.7% y/y	Consensus: 2.7% y/y	Previous: 2.4% y/y

Comment: We expect headline inflation to be confirmed at 2.7% in April, from 2.4% y/y in March. With regard the detailed breakdown our projections show that core inflation could have increased again to 1.5% y/y, driven by an expected rebound in the prices of non-energy industrial goods. Processed food prices are likely to have increased further, while service inflation should have remained broadly stable. In addition, recent fuel prices available for April suggest that energy prices should have increased further, but at a more moderate pace. **Market Impact:** A further acceleration in core inflation could increase market concerns about tighter ECB monetary policy in order to face second round effects.

US: FOMC Rate Decision (Wednesday 12:30 ET)

Forecast: 0.25%	Consensus: 0.25%	Previous: 0.25%

Comment: The Federal Reserve will meet for a regular two-day meeting. In the meeting, the FOMC members will reveal their latest macroeconomic economic forecasts which will be released three weeks following the statement. This time, the statement will be released earlier than in the previous meetings due to the Fed's new communication strategy. Starting on April 27, the chairman Ben Bernanke will hold a press conference after each two-day meeting in order to ensure clarity of objectives and implementation of monetary policy to the markets. We expect no significant changes in the statement and the FOMC's decisions. The Fed is expected to keep the federal funds rate unchanged, implement QE2 as planned and continue its current policy of reinvesting interest gains from MBS into Treasury securities. Our baseline scenario assumes that the Fed will start hiking the federal funds target rate in March 2012. **Market impact:** If Bernanke's press conference or statement reveals any clues about the timing and pace of the exit strategy, markets will price it accordingly.

US: Personal Income and Outlays (March, Friday 08:30 ET)

Forecast: 0.5%, 0.5%	Consensus: 0.4%, 0.5%	Previous: 0.3%, 0.7%

Comment: We expect personal income and spending to continue increasing in March. They have increased 0.5% MoM in the last two months due increase in consumer prices. Therefore, real personal spending, for example climbed only by 0.1% MoM compared to 0.2% MoM increase in the previous 12 months. Due to sharp increases in oil and foods prices, consumers are left with less money to spend on other goods and services. Therefore, we forecast weaker real personal consumption expenditures in 1H11 than previously expected. **Market impact:** If real personal spending jumps significantly higher than the market expectation, it would imply higher economic growth in 1Q11 and push stock prices up.

Korea: Q1 real GDP (April 27)

Forecast: 4.6% y/y	Consensus: 3.9% y/y	Previous: 4.7% y/y

Comment: The early GDP releases from Korea, together with China and Singapore, serve as a bellwether for growth prospects in the region. China and Singapore have already released better-than-expected Q1 outturns, and a strong reading for Korea would confirm the region's strong growth in Q1, despite headwinds from surging oil prices and, going forward, the impact from Japan's earthquake. We expect GDP growth to reach 4.5% in 2011, following last year's 6.1% outturn. **Market impact:** A better-than-expected outturn could strengthen expectations of more aggressive interest rate hikes, while a weaker outturn would do the opposite, especially given headwinds to growth in the coming quarters.

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Markets Data

			Close	Weekly change	Monthly change	Annual change
Interest Rates (changes in bps)	US	3-month Libor rate	0.27	0	-4	-4
		2-yr yield	0.67	-10	4	-32
		10-yr yield	3.39	-11	6	-35
	EMU	3-month Euribor rate	1.35	2	17	71
		2-yr yield	1.85	-2	12	97
		10-yr yield	3.32	-11	8	24
Exchange Rates (changes in %)	Europe	Dollar-Euro	1.448	0.0	1.8	8.0
		Pound-Euro	0.89	0.0	1.6	1.8
		Swiss Franc-Euro	1.29	0.1	0.5	-9.8
	America	Argentina (peso-dollar)	4.07	0.3	0.9	5.2
		Brazil (real-dollar)	1.58	-0.3	-5.3	-10.0
		Colombia (peso-dollar)	1789	-0.8	-4.5	-8.2
		Chile (peso-dollar)	473	0.1	-1.3	-9.3
		Mexico (peso-dollar)	11.62	-0.9	-2.9	-4.5
		Peru (Nuevo sol-dollar)	2.82	-0.3	1.4	-0.8
	Asia	Japan (Yen-Dollar)	82.76	-0.9	2.1	-11.3
		Korea (KRW-Dollar)	1079.00	-0.6	-3.5	-2.9
		Australia (AUD-Dollar)	1.065	1.0	6.0	14.6
Comm. (chg %)		Brent oil ($/b)	122.8	0.3	6.8	43.3
		Gold ($/ounce)	1502.5	1.9	5.2	31.0
		Base metals	629.9	-0.6	2.1	22.7
Stock Markets (changes in %)	Euro	Ibex 35	10498	-1.2	-0.7	-5.1
		EuroStoxx 50	2902	-0.5	1.4	-1.6
	America	USA (S&P 500)	1313	-0.1	1.1	8.8
		Argentina (Merval)	3332	-1.5	0.0	37.5
		Brazil (Bovespa)	66158	-0.2	-0.8	-4.6
		Colombia (IGBC)	14053	-0.1	-4.1	12.6
		Chile (IGPA)	22194	0.3	5.1	24.0
		Mexico (CPI)	36440	-1.7	2.9	8.7
		Peru (General Lima)	18999	1.4	-11.1	21.1
		Venezuela (IBC)	70871	0.6	1.4	18.7
	Asia	Nikkei225	9607	-0.5	4.3	-13.4
		HSI	23896	-0.5	5.3	11.1
Credit (changes in bps)	Ind.	Itraxx Main	101	4	-1	18
		Itraxx Xover	373	4	-7	-42
	Sovereign risk	CDS Germany	46	2	-1	10
		CDS Portugal	610	17	92	385
		CDS Spain	241	22	31	84
		CDS USA	46	4	4	---
		CDS Emerging	205	3	-11	-2
		CDS Argentina	571	12	-57	-272
		CDS Brazil	110	2	-5	-3
		CDS Colombia	102	1	-13	-27
		CDS Chile	60	0	-8	-21
		CDS Mexico	103	2	-6	0
		CDS Peru	151	-2	26	41

Source: Bloomberg and Datastream

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