BBVA Research

Global

Weekly Watch

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Economic Analysis

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Strong Growth in Emerging Markets

Strong domestic growth in Emerging markets (EM) and rising commodity prices are lifting inflation expectations, paving the way for the interest rates normalization process. In some countries this process has already started: China, Hong Kong, Korea, Singapore and Brazil. In our view, policymakers across Asia and LatAm countries will be mainly focused on controlling inflation, and other policies will likely be implemented in order to avoid exchange rate appreciation.
In China, recent economic indicators point to a very strong growth momentum (2010 GDP growth rose to 10.3%). Main data indicate robust consumer spending and investment. Underlying inflation pressures remain high (non-food components and property prices showed further increases).

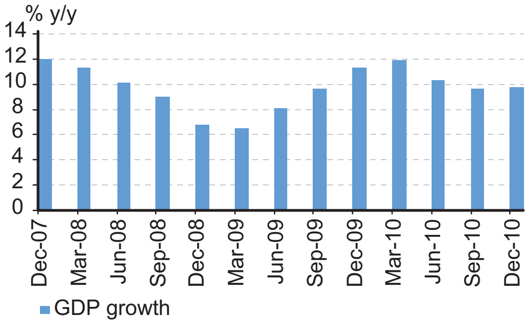
Markets give sovereign risk a break

All signs indicate that we will have to wait until March to get a full package of measures that put an end to funding and solvency problems in highly indebted European countries. Sovereign risk may stabilize until March if peripheral countries continue with their expected reforms. In this regard, the Spanish Council of Ministers is expected to pass the Pension Reform next Friday. Also, Spanish government is taking new steps in the banking restructuration process. On the other hand, there are other factors that could introduce some noise in the markets, like the Irish elections in March, or the recent debate regarding a possible Greek debt restructuring.

Next week we will be watching…

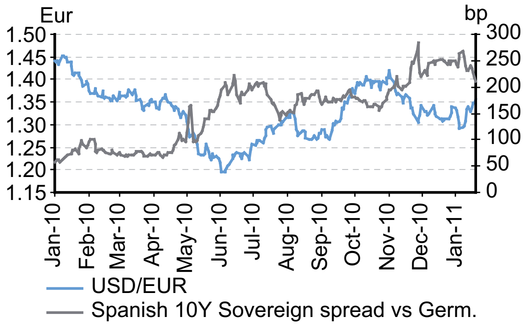
The FOMC meeting, where the communication strategy will focus on rebalancing the risk of deflation but not to a point where the risks to growth and inflation are balanced. The main focus remains on the economic recovery. Therefore, we do not expect changes either to the monetary policy stance or to QE2. In the Eurozone we expect the first EFSF bond issue, which will be a good proxy of how markets perceive Eurozone sovereign risk.

Chart 1
China's fourth quarter GDP growth surprises to the upside…



Source: Bloomberg and BBVA Research

Chart 2
Eurodollar vs Spanish Sovereign spread



Source: Bloomberg and BBVA Research

Highlights

Inflation outlook

We do not see serious inflation problems in developed countries due to slack domestic demand. Emerging countries are on the opposite side.

Monetary policy dilemma in Emerging markets

In the event of stronger inflationary pressures, we would expect central banks to tighten policy more aggressively allowing some currency appreciation.

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Markets

Climbing Commodities' prices do not fully reflect the situation in physical markets…

At the end of 2010 and the beginning of 2011, there were certain problems affecting energy and food supply. The floods in Australia have affected a region that supplies close to half the world's coal production, meaning that in the short term, there may be more demand for substitutes, such as fuel oil and diesel. In addition, there has been a problem with the oil pipeline running between Alaska and the United States (600.000 b/d), as well as a fire at an oil sands plant (110,000 b/d) in Alberta, constricting supply in the short term. In soft commodities, the possible supply problems in Argentina caused by the "Niña" phenomenon have pushed corn prices up to over USD 6.5, the highest level seen since June 2008. While the international scenario is not so severe, US inventory forecasts are at their lowest levels in the last 15 years.

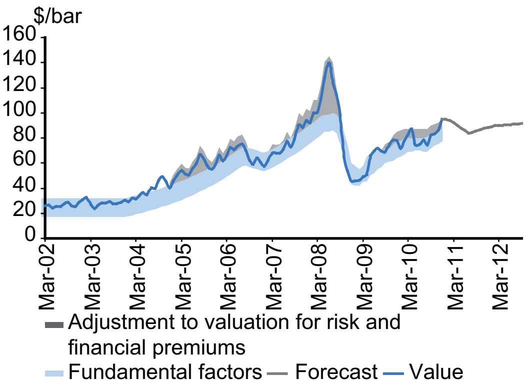
Broadly, there are no supply-side problems in any of the underlyings in our opinion, although exists a certain perception by markets of scarcity in the long term. In any event, we should bear in mind that the current surge in prices should spur companies to invest in new capacity and this should result in replenished supplies. In the case of metals, we have seen how high prices have resulted in a notable increase in investment, although these investments may take several years to bear fruit.

In our opinion, the current dynamic of climbing prices does not fully reflect the situation in physical markets. We could see a limited correction to the degree that investment flows into commodities decrease. Oil is showing the best fundamentals, with a gradual tightening in the medium-long term, while the metals zinc and nickel have the most ample balances for the upcoming year. As for soft commodities, we expect output reviews in Argentina to make the market volatile until March, although we consider that the worst is already behind us. In the short term, prices could remain under pressure but if no more negative news is forthcoming on the supply side, they should start to moderate. Lastly, price pressure on other grains could continue to push wheat prices up although inventory levels are much more comfortable than for corn. Stable supply could cause wheat prices to fall. To sum up, oil has better supports than metals and agricultural raw materials in the medium term, although we also expect its price to drop slightly over the coming months

… but they are causing interest-rate curves to trend upwards

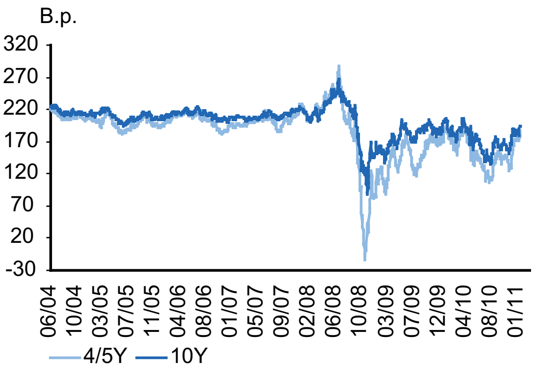
This week's catalyst was UK inflation, where the rise to 3.7% has renewed market sensitivities in this respect to levels not seen since last May (see inflation breakevens for France). As we consider inflationary pressure to be transitory, we reinforce our view that interest rates are already close to their highs, and this is compatible with breakevens finding it difficult to break through the levels recently established.

Chart 3
Oil Price (Brent)



Source: Datastream & BBVA Research estimates

Chart 4
France: Inflation Breakeven



Source: Datastream & BBVA Research estimates

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Highlights

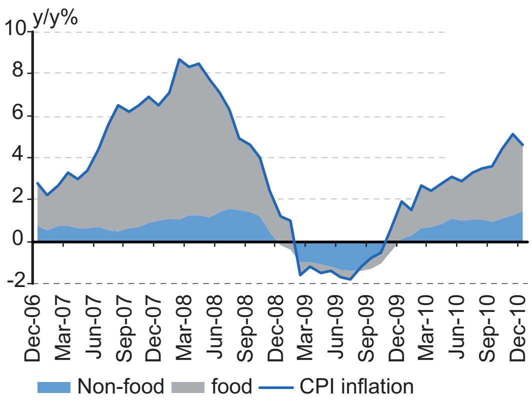
Inflation outlook

Considering the recent upturn in inflation worries we have decided to include our inflation outlook for the main economic areas. Regarding inflation trends, we can distinguish three groups of countries. The first one includes countries lacking significant inflation pressures. That is the case of the US, where price increases will continue but at a moderate pace. The slack remains elevated in the US and so far, the shock should not contaminate inflation expectations. The second group consists of the Eurozone and Mexico. In both, inflation rates are above Central Banks' targets (although Mexico is on the lower bound of the medium term Banxico target). In Mexico inflation reached maximum levels of 4.4% in December and we expected a rapid downturn due to a base effect. In the Eurozone, the recent upward trend in inflation should be temporary, reverting from 2Q2011 as a consequence of lower energy inflation in coming months due to a base effect in the energy component and expectations of lower prices in the Brent barrel. In addition, core inflation will remain low due to the absence of inflationary pressures on the domestic demand side in both countries. Finally, the third group includes countries where inflation is becoming a concern due to a combination of rising commodity prices and increasing domestic pressures. That is the case in LATAM and Asia. We are in a process of revising up our 2011 inflation forecasts (period averages) for Asia while our latest baseline incorporates rising inflation; overall levels are expected to remain modest: first, supply side factors are likely to be temporary; and second, a moderation in growth rates toward potential, as reflected in our baseline, should help reduce demand pressures. On the policy front, government measures to improve supply and ensure distribution of key staples should help. In addition, monetary tightening and currency appreciation should help to contain inflation. Based on the above, we expect inflation in most Asian countries to peak in mid-2011, and gradually ease thereafter.

Monetary policy dilemma in Emerging markets

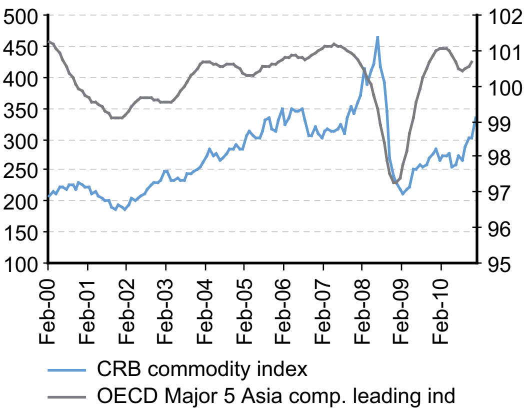
Since the second half of last year Emerging Countries have cooled down currency appreciation by imposing capital controls and delaying interest rate hikes. But this pattern is changing. In the face of increasing inflation pressures and closed output gaps, policymakers across Asia have already switched from nurturing growth to maintaining price stability. Some governments have resorted to various price controls (these have been quite limited so far). More importantly, on the monetary front, interest rate normalization is now underway, featured by rate hikes in Korea (Jan 2011), Thailand (Jan 2011), China (Dec 2010), and Taiwan (Dec 2010). We expect central banks to maintain a tightening bias in 2011, with four more 12.5bp hikes in Taiwan, and three more 25bp hikes in China, India, Indonesia and Korea. These are likely to be supplemented by additional quantitative measures to absorb liquidity through hikes in reserve requirements and open market operations. In the event of stronger inflationary pressures, we would expect central banks to tighten policy more aggressively. In such a case, capital inflows would be absorbed through a combination of allowing currency appreciation, along with sterilized intervention to slow the pace. It is possible that further macro-prudential measures could be used to limit inflows, but we would not expect severe capital controls. In the case of LATAM countries our view is that Central Banks would increase tightening bias if supply shocks translate into second round effects. Brazil increased rates (50bp) this week. They would strengthen capital controls and macro-prudential policy in order to avoid the exchange rates to further appreciate. Overall the risks are for an increase in the tightening bias with some currency appreciation.

Chart 5
China: CPI inflation eases, although underlying pressures remain



Source: Bloomberg and BBVA Research

Chart 6
Commodity prices vs Asian activity



Source: Bloomberg and BBVA Research

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Calendar: Indicators

Eurozone: Flash PMI Composite (January, January 24th)

Forecast: 55.1	**Consensus:** 55.5	**Previous:** 55.5

Comment: We see the composite PMI index in January slightly moderating from the current high levels, as the rebound of recent months should be behind us and the timid decline observed in the previous two quarters continues. The expected moderation results from a stabilization in manufacturing sentiment that should be offset by the confidence decline in the service sector. Across countries, it is unlikely that the divergence observed in recent months starts to reverse. **Market Impact:** A sharper decline in the PMI index could be damaging, as the mood in European economies continues to be marked by concerns surrounding peripheral countries.

Eurozone: M3 (December, January 28th)

Forecast: 2.0% y/y	**Consensus:** 2.0% y/y	**Previous:** 1.9% y/y

Comment: Eurozone lending data for December are expected to reflect the positive sentiment observed in recent months, although there is still a very cautious tone rather than a clear recovery. In particular, M3 is expected to have increased further over the previous month, resulting in a higher year-on-year rate at around 2.0% y/y. Across its counterparts, loans to households are projected to have continued growing at similar rates to those recorded over the last year (around 0.2% m/m), while those to non-financial corporations are likely to have increased slightly (also around 0.2% m/m), after hovering around 0% m/m since the beginning of the year and thus reverting to positive annual rates for the first time since August 2009. **Market impact:** A sharp decline in loans to private sector could be read by markets as a sign that European banks are having difficulties in providing credit to sustain the recovery.

US: FOMC Rate Decision (January, January 26th)

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

Comment: Minutes of the last FOMC meeting held on December 14, 2010 and recent speeches by FOMC members indicate that most of the voting members in FOMC believe the U.S. economy is growing at a moderate pace but the unemployment rate will remain elevated in coming quarters. FOMC members expect that the inflation rate will continue to be below the level consistent with price stability and maximum employment, although the risk of deflation has receded somewhat. We expect that the Fed will leave the federal funds target rate unchanged and continue its current LSAP program until its scheduled completion at the end of 2Q11. However, the Fed will continue to monitor economic conditions and over the course of the following meetings the Fed will begin to consider how to craft a communication strategy for either the end or the continuation of the LSAP program. **Market impact:** If the Fed hints or announces a change in its current monetary policy, the interest rates will quickly react to the news.

US: Gross Domestic Product, Advanced (4Q10, January 28th)

Forecast: 3.3% Q/Qa	**Consensus:** 3.5% Q/Qa	**Previous:** 2.6% Q/Qa

Comment: 4Q10 GDP growth is expected to be stronger than previously expected, primarily due to consumer spending and exports, which are picking-up faster than anticipated. In the last three months, macroeconomic indicators, such as retail sales and exports, point to an increase in economic activity. Our short-term models indicate a quarterly annualized growth rate of 3.3% in 4Q10. If this is the case, it would mean that the U.S. economy grew 2.9% in 2010, slightly above our baseline scenario of 2.8%. **Market impact:** Some economists are forecasting more than 5% GDP growth in 4Q10. If the U.S. economy grew close to 5%, then economists will have to revise up their growth estimates for 2011.

Singapore: CPI inflation (December, January 24th)

Forecast: 4.5% y/y	**Consensus:** 4.5% y/y	**Previous:** 3.8% y/y

Comment: Inflation is expected to end the year at a relatively high level of 4.5%y/y, due to base effects and rising price food and housing costs. The government is aiming to contain inflation in 2011 to 2-3% by tightening monetary policy through faster currency appreciation. **Market impact:** A higher-than-expected inflation reading would raise expectations of further currency appreciation.

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				Close	Weekly change	Monthly change	Annual change
Interest Rates	(changes in bps)	US	3-month Libor rate	0.30	0	0	5
			2-yr yield	0.63	6	-1	-16
			10-yr yield	3.46	13	11	-15
		EMU	3-month Euribor rate	1.03	2	0	36
			2-yr yield	1.29	14	34	18
			10-yr yield	3.19	16	23	-3
Exchange Rates	(changes in %)	Europe	Dollar-Euro	1.356	1.6	3.6	-4.2
			Pound-Euro	0.85	0.9	-0.4	-3.4
			Swiss Franc-Euro	1.30	1.1	4.4	-11.6
		America	Argentina (peso-dollar)	3.98	0.2	0.2	4.6
			Brazil (real-dollar)	1.67	-0.8	-1.5	-7.9
			Colombia (peso-dollar)	1838	-1.7	-4.4	-6.6
			Chile (peso-dollar)	492	0.6	4.9	-3.2
			Mexico (peso-dollar)	12.02	-0.4	-2.4	-7.1
			Peru (Nuevo sol-dollar)	2.77	-0.5	-1.0	-2.8
		Asia	Japan (Yen-Dollar)	82.77	-0.2	-1.0	-8.0
			Korea (KRW-Dollar)	1120.00	0.4	-2.8	-2.7
			Australia (AUD-Dollar)	0.990	0.0	-1.0	9.5
Comm.	(chg %)		Brent oil ($/b)	97.2	-1.5	3.8	33.5
			Gold ($/ounce)	1341.5	-1.5	-3.2	22.7
			Base metals	595.3	0.8	2.6	21.0
Stock Markets	(changes in %)	Euro	Ibex 35	10909	5.0	7.1	-4.1
			EuroStoxx 50	2998	2.7	4.5	5.7
		America	USA (S&P 500)	1290	-0.3	2.5	18.1
			Argentina (Merval)	3691	4.3	6.2	58.3
			Brazil (Bovespa)	69881	-1.5	2.1	5.5
			Colombia (IGBC)	14974	-1.3	-3.5	29.8
			Chile (IGPA)	23062	-0.5	1.0	32.2
			Mexico (CPI)	37688	-0.8	-1.3	22.2
			Peru (General Lima)	21694	-0.5	-4.5	45.9
			Venezuela (IBC)	65851	-0.1	1.0	11.1
		Asia	Nikkei225	10275	-2.1	-0.7	-3.0
			HSI	23877	-1.7	3.6	15.2
Credit	(changes in bps)	Ind.	Itraxx Main	103	-2	-2	21
			Itraxx Xover	419	5	-18	-31
		Sovereign risk	CDS Germany	58	-1	1	23
			CDS Portugal	458	-23	-31	309
			CDS Spain	278	-23	-70	148
			CDS USA	43	0	0	---
			CDS Emerging	203	3	-4	-63
			CDS Argentina	549	17	-61	-483
			CDS Brazil	111	4	-3	-28
			CDS Colombia	112	4	-4	-47
			CDS Chile	79	0	-7	4
			CDS Mexico	113	4	-3	-32
			CDS Peru	110	5	-8	-27

Source: Bloomberg and Datastream

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