

Weekly Watch

Global

Madrid, 22 July 2011
Economic Analysis

Financial Scenarios
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Not all uncertainties are lifted

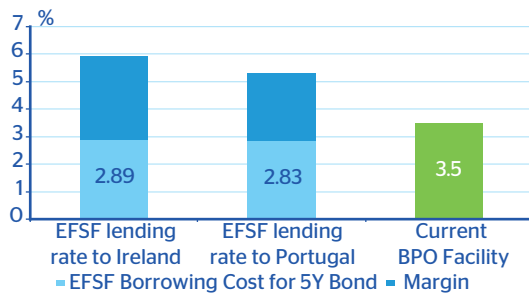
Global risk premiums are currently determined by two threatening crises: 1) the European sovereign debt crisis and 2) a necessary raising of the US debt ceiling (see highlight). This week brought encouraging compromises to address the first issue, while we're still waiting for a resolution on the second one. The EU council summit on 21 July took steps towards dealing with the debt crisis in the periphery that surprised on the upside. Europe is reducing rates and extending maturities for loans to Greece, Portugal and Ireland; the EFSF is being made more flexible, liable to be used in secondary markets and as a tool to recapitalise banks and help non-rescued countries; private participation has not been defined in detail but is expected to make a large contribution (yet they are only "estimates"). There is also a clear separation in the scope of the private sector involvement between Greece and the rest of the Eurozone. On the negative side, there is no increase in EFSF funds and the implementation of its flexibility has still to be defined. In the longer term, the fact that the Greek debt ratio is not likely to be reduced by much, and that Greek reforms are subject to strong implementation risks implies that negative surprises cannot be ruled out further down the road. But, all in all, it is a very good agreement that should calm markets for a while, and possibly provide the framework for a long-lasting solution for the EU crisis.

Debate on US budget and debt ceiling will be in the spotlight

Economic data has been weak in Europe while giving mixed signals in the US. In the Eurozone the PMI composite fell to 50.8 in July, close to the expansion/contraction threshold. In the US, housing data came in better than expected in June, showing an increase in building permits which points to a less sluggish housing market. Meanwhile labor data continued pointing to weakness in the labor market. In Asia the rebound in Japanese exports added to evidence of resumption in supply channels, which may pave the way for a recovery in the industrial activity around the world. However, Eurozone PMI data did not reflect this positive effect in July. In Latam, central banks have continued implementing macropudential measures to alleviate appreciation pressures.

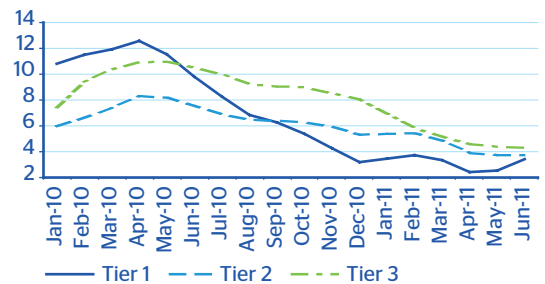
The main issue for next week will be developments on the debate of the US budget and debt ceiling. On the economic side US 2Q GDP figures and the Eurozone July CPI will be released.

Chart 1
EU Council proposal will cut EFSF loan lending rates equivalent to BPO facility



Fuente: EFSF and EU Council

Chart 2
China's smaller cities may see large housing price gains (% y/y)



Source: BBVA Research and Bloomberg

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Highlights

US debt ceiling: Republicans and Democrats still not close to an agreement

But short-term fixes could be approved (not vetoed), averting a default.

The second European bank stress test...

...did not help to dispell uncertainties over the financial sector.

China signals plans to extend curbs on housing purchases to smaller cities

With signs of cooling in the big cities, smaller cities are now expected to see the largest price gains.

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Credit market strengthened by agreement

In credit, the iTraxx Main benchmark index has narrowed by around 20bp since the start of the week, and now stands at 108bp, in anticipation of the new measures which have been adopted by the EU. By sectors, financial debt has performed notably better, with the iTraxx Fin Senior narrowing 40bp to 155bp and subordinated debt 65bp to 275bp in the same period.

By countries, Spanish and Italian banks have rallied strongly. Santander and BBVA's Senior CDS have tightened from 290bp and 305bp on Monday, respectively, to 215bp and 235bp today. Meanwhile, Unicredito's CDS has narrowed from 341bp to 236bp, tightening by more than 100bp over this period.

In our view, valuations still offer some upside in the short term, due to the severe penalization seen in the last two months. Improved investor sentiment may lead to the primary market reopening next week following a long period of extremely low issuance volumes.

EURUSD Still within a wide range

We believe that although the headlines after Eurogroup announcement are initially positive and EURUSD could run another 1.0-1.5% higher in the next few days, the bulk of the near-term move appears to have taken place and we are continuing to message a general EURUSD trading range of 1.3800 - 1.4400. Our US economics team continues to believe we will see a positive resolution to the US debt ceiling issue and that should take some of the negative glare off USD in the coming days - so long as S&P does not initiate an immediate downgrade in its US credit rating. That said, non-commercial CFTC EUR positions are likely not overly long at present and given today's EU announcement the risk appears to be hedge funds and CTA's legging into long-EUR positions near-term and pushing EURUSD above our expected trading range. Additionally EURUSD's close right around trend line resistance circa 1.4420 (May 2011 highs of 1.4940) on Thursday suggests EURUSD is at key crossroads technically near-term and a second daily close above 1.4420 will likely get momentum players talking about a higher EURUSD. For now, we continue to be comfortable messaging a one-month EURUSD forecast of 1.4400 as we await resolution of the US debt ceiling issue.

General interpretation positive in terms of the risk premium

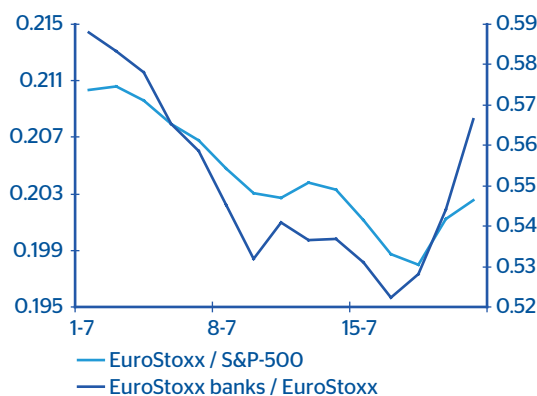
European equity markets' performance is dominated by debt markets. Fortunately, however, they are still supported by multinationals' earnings and the global economic cycle. If the spread of Spanish and Italian sovereigns over German sovereigns continues to narrow, equity markets will have a lot of upside potential, above all from the let-up for the banking sector.

In 2H11 the EuroStoxx 50 could rally by 20% and the Ibex 35 by 15% provided they are supported by the financial sector. In fact, the Ibex-35 is in an even more polarized situation than the Eurostoxx 50, since in general Spanish banks only have Spanish debt on their balance sheets, and unless there is a contagion of Spain their income statements remain relatively immune, at least initially, to Greek and Irish bonds. Holdings of Portuguese bonds would have a minor impact on Spanish banks' earnings in 2011, and no impact in 2012.

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Chart 3

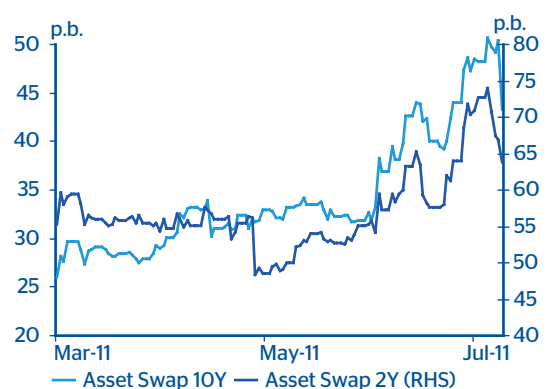
Relative performance of EuroStoxx vs. S&P-500 and vs. the eurozone Banking sector



Source: eurozone Banking sector

Chart 4

Asset Swap



Source: Bloomberg and BBVA Research

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US debt ceiling: Republicans and Democrats still not close to an agreement

The momentum that was gained after President Obama endorsed a \$3.7tr debt ceiling package produced by the "Gang of Six" appeared to be lost after House Republicans, specifically Tea Party-backed members, remained firm on avoiding tax increases and the White House continued its largely opposing stance. Although somewhat acceptable to the White House, the Gang of Six's proposal would still meet resistance because it includes both spending cuts and tax increases. Currently, details suggest the bill will cut \$1.4tr in discretionary spending and \$740M in entitlements, while increasing tax revenues through a broadening of the tax base and abolition of the alternative minimum tax. Late Wednesday afternoon, the White House conceded that short-term fixes could be approved (not vetoed). An alternative plan passed by the House, which includes a constitutional debt limit amendment, would have an almost impossible path of opposition in the Senate and is almost assured a presidential veto. The procedural implications of House and committee approval are increasing the political brinksmanship, with little time to accommodate such opposition. Neither side wants to appear unduly conciliatory. Conversely, neither party wants to bare the stain of default close to an election. The debt ceiling appears more pressing given S&P reporting that anything less than a \$4.0tr debt reduction would result in a downgrade. Recent contagion and sovereign debt worries worldwide have increase the frequency of ratings agencies' commentaries on national debt negotiations in general. Time is running low for legislation to pass through Congress in time. If the House blockage results in default and subsequent downgrade, the most immediate effects would be a possible \$2.5bn increase in interest payments on this year's maturing debt, assuming the rating downgrade results in a 50bp rise in sovereign borrowing rates and related pass-through to state and municipality debt. For the U.S. to avoid a ratings downgrade it appears the current proposal, or a close derivative of it, must be approved. For the US to avoid default, at the very least a short-term procedural fix passed through Congress is necessary to maintain financial stability.

The second European bank stress test

On 15 July the EBA released the results of the second European Stress Test. Despite the stricter methodology and more stringent hypotheses, the results were disappointingly similar to those of previous year. The wider coverage (and hence transparency) in Spain is no longer a surprise, which explains that the market reaction has not been positive (quite the opposite). On the negative side, the limited extent of the sovereign stress and the absence of a liquidity stress (although the increase in the cost of funding is part of the determination of the net interest income in the adverse scenario) diminished the credibility of the exercise. On the positive side, the information provided is much more comprehensive than last year, especially as concerns sovereign exposure, and allows analysts to perform their own tests. In any case, the mood of the markets is dominated by the sovereign crisis in the Eurozone and the attention received by the stress test was limited.

China signals plans to extend curbs on housing purchases to smaller cities

As noted in our [China Real Estate Outlook](#) report published last week, the housing market has cooled over the past year under the influence of government tightening measures. At a national level, basing our estimates on official (NBS) data released this week, prices of residential properties increased 3.4% y/y in June, up slightly from 3.0% in May, but continuing a moderating trend since last year. However, for some time now, prices have been rising faster in smaller cities (Chart 2). Indeed, our report flagged that slower price increases to date and strong growth prospects in second and third tier cities, mean that the best investment opportunities lie in the smaller cities. To forestall price bubbles in these cities, the authorities have just signalled their intention to expand restrictions in the large cities to the smaller ones. Details have not yet been announced.

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Calendar: Indicators

Eurozone: Flash HICP inflation (July, 29 Jul)

Forecast: 2.7% y/y	Consensus: 2.7% y/y	Previous: 2.7% y/y
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Comment: We expect the July HICP inflation figure to have remained broadly stable, as observed in previous months, as the recent increase in oil prices is compensated by a slight moderation in core inflation, although the detailed breakdown will not be released until mid-August. Core inflation should have benefited from some moderation of non-energy industrial prices as a consequence of the summer sales effect combined with lower prices in services, mostly those more depending the reversion linked to past indirect effects from higher energy prices (transport services, for instance).

Market Impact: A further acceleration in core inflation could increase market concerns about higher indirect effects that could result in tighter monetary policy.

Eurozone: Money Supply (June, 27 Jul)

Forecast: 2.2% y/y	Consensus: 2.4% y/y	Previous: 2.4% y/y
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Comment: Eurozone lending data for June are expected to reflect a still sluggish credit performance. M3 growth is projected to have declined slightly, after the rebound observed in May, hovering around 2% as it has done since late 2010. Across its counterparts, loans to households are expected to have increased further, albeit at a more modest pace than that observed at the beginning of the year. Loans to non-financial corporations are likely to continue at its subdued pace. Overall, these figures imply a slight moderation in credit expansion in Q2. **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.

US: Consumer Confidence (July, 26 July)

Forecast: 57.9	Consensus: 58.3	Previous: 58.5
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Comment: Consumer confidence is expected to decline in July for the third consecutive month, mainly due to the unenthusiastic employment outlook. Less favorable labor market conditions are likely to weigh on personal spending habits, with fewer consumers foreseeing improvements over the next six months. Falling gas prices may help to balance the impact of the disappointing employment situation, however we expect that uncertainty regarding future earnings will drive down overall consumer activity.

Market impact: We do not expect markets to move drastically if consumer confidence falls slightly again this month, although a larger-than-expected drop will cause a negative reaction.

US: Gross Domestic Product, Advanced (2Q11, 29 July)

Forecast: 1.7%	Consensus: 1.7%	Previous: 1.9%
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Comment: The deteriorating economic condition suggests slower growth in 2Q11. Consumer indicators including confidence survey's, retails sales, and personal consumption expenditures were down from 1Q11 readings. In addition, manufacturing survey reports were below 1Q11 levels, and combined with slow residential investment and moderated core capital goods production point to QoQ deceleration in private investment. Furthermore, public investment will continue to decline as state and local governments address budgetary issues and federal debt policies restrict fiscal spending. In regards to net exports, we expect the continued expansion in imports to offset the acceleration in exports in the 2Q11. **Market Impact:** Though much of the market expectations are priced in, the recent volatility suggests markets are still concerned about 2011 growth and weak labor markets. Strong 2Q11 growth could bolster expectations and also offset some of the uncertainty generated by federal deficit and debt negotiations

Korea: GDP growth (Q2, 27 July)

Forecast: 3.5% y/y	Consensus: 3.8% y/y	Previous: 4.2% y/y
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Comment: Korea's economic growth is likely to have slowed in Q2, as both exports and industrial production have moderated in recent months due to a combination of supply chain disruptions from Japan and high commodity prices. Last Friday the Bank of Korea also lowered its GDP outlook for 2011 to 4.3% from 4.5% previously, stressing that downside risks to growth have outweighed upside risks for the time being. Nevertheless, Korea has been relatively less affected by external headwinds given its strong export competitiveness, and we expect a gradual rebound in H2. For the whole year 2011, we expect the economy to expand 4.5%. **Market impact:** a lower-than-expected Q2 GDP growth could reduce expectations of interest rate hikes by the Bank of Korea.

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			Close	Weekly change	Monthly change	Annual change
Interest Rates (changes in bps)	US	3-month Libor rate	0.25	0	1	-24
		2-yr yield	0.38	3	1	-21
		10-yr yield	2.98	7	-1	-2
	EMU	3-month Euribor rate	1.61	0	9	73
		2-yr yield	1.38	16	-10	63
		10-yr yield	2.82	12	-13	11
Exchange Rates (changes in %)	Europe	Dollar-Euro	1.435	1.4	-0.5	11.6
		Pound-Euro	0.88	0.5	-1.4	5.6
		Swiss Franc-Euro	1.17	1.6	-2.7	-13.4
	America	Argentina (peso-dollar)	4.14	0.4	1.0	5.3
		Brazil (real-dollar)	1.56	-1.0	-1.8	-11.7
		Colombia (peso-dollar)	1756	0.1	-1.4	-6.0
		Chile (peso-dollar)	461	-0.3	-2.3	-11.5
		Mexico (peso-dollar)	11.65	-0.6	-1.1	-8.7
		Peru (Nuevo sol-dollar)	2.74	-0.2	-0.7	-3.1
		Japan (Yen-Dollar)	78.37	-0.8	-2.2	-10.2
	Asia	Korea (KRW-Dollar)	1051.38	-0.7	-2.1	-12.3
		Australia (AUD-Dollar)	1.085	1.9	2.1	21.3
Comm. (chg %)	Brent oil (\$/b)	117.7	0.3	3.0	51.9	
	Gold (\$/ounce)	1605.6	0.8	3.7	35.0	
	Base metals	594.0	0.0	-0.6	24.8	
Stock Markets (changes in %)	Euro	Ibex 35	10074	6.2	-1.5	-3.0
		EuroStoxx 50	2765	3.4	-1.1	1.7
		USA (S&P 500)	1340	1.8	4.1	21.5
	America	Argentina (Merval)	3366	1.2	1.0	41.7
		Brazil (Bovespa)	60281	1.3	-1.5	-9.1
		Colombia (IGBC)	13850	5.5	-3.0	4.4
		Chile (IGPA)	22096	-1.4	-0.9	10.3
		Mexico (CPI)	35441	-2.0	0.1	8.0
		Peru (General Lima)	22186	9.0	15.9	56.8
		Venezuela (IBC)	87065	1.2	9.0	35.2
	Asia	Nikkei225	10132	1.6	5.2	7.4
		HSI	22445	2.6	2.7	7.8
Credit (changes in bps)	Ind.	Itraxx Main	112	-11	2	0
		Itraxx Xover	419	-40	9	-87
	Sovereign risk	CDS Germany	55	-3	13	15
		CDS Portugal	946	-197	162	677
		CDS Spain	309	-37	25	108
		CDS USA	53	-2	2	---
		CDS Emerging	213	-9	-13	-18
		CDS Argentina	608	-22	-22	-239
		CDS Brazil	112	-5	-2	-8
		CDS Colombia	111	-4	1	-16
		CDS Chile	73	-2	-2	-16
		CDS Mexico	111	-4	1	-10
		CDS Peru	122	-7	-24	9

Source: Bloomberg and Datastream

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