BBVA Research

Global

Weekly Watch

Madrid, 25 February 2011

Economic Analysis

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Oil prices cause concern

The civil unrest in the Middle East and North Africa (MENA) is spreading to other countries that have an important share of world oil resources (10% of world oil production). As a result of increasing concerns, Brent prices rose USD10 this week, pushing up inflation expectations and increasing fears of a possible need for some emerging countries to further tighten monetary policy, hampering economic growth in the process.

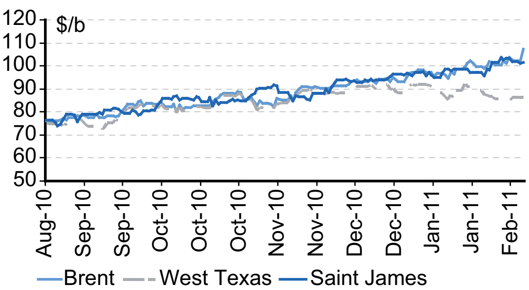
Hawkish tone likely to harden

Markets will be expectant ahead of the BoE and ECB monetary policy meetings. We do not expect any changes to monetary stances for either the BoE or the ECB, but both are likely to stress their hawkish tones. Recent strong economic data (e.g. soft economic data for February in the Eurozone) together with further signs of short-term price pressures warrant this. Accordingly, the last BoE minutes suggested that committee members have become more worried about inflation (a new member has joined the group of members voting for a rate hike) while ECB council members have recently hardened their hawkish rhetoric (Mersch's comments suggesting they might consider shifting the balance of risks to the upside stood out). Nonetheless, we think that the conditions needed to trigger a change in the loose stance are still not present and they may prefer to postpone the first move as much as possible. Thus, the risk assessment for medium-term price stability will remain unchanged i.e. they will not give any signals that they intend to hike rates in the short-term. Other than that, the ECB will decide to wait on the resumption of "exit steps" of non-standard measures: an extension of the full-allotment for the 3-month LTROs will be announced.

Next week also...

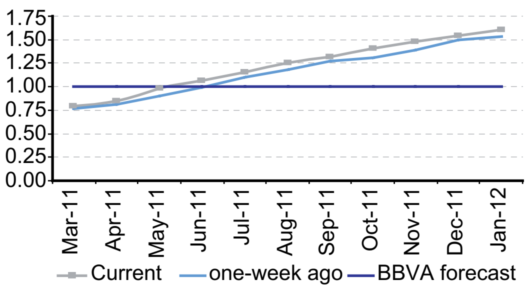
...brings with it important economic events in both the US and the Eurozone. In the US, we get a first feel of February with the important ISM and payroll reports. With regards to Eurozone inflation we get the flash for February along with January's final figure. More market noise about European governance issues is likely ahead of the March 11th EU Council meeting. Markets will closely follow Merkel and Schaeuble's interventions. Once again Germany reiterated its opposition to a Eurobond issue.

Chart 1
Middle East Unrest Pressure on Oil Prices



Source: Bloomberg and BBVA Research

Chart 2
Eurozone: Implicit ECB Rates in EONIA Fut.



Source: Bloomberg and BBVA Research

Highlights

Unrest in MENA countries

Will cause risk premiums to remain high.

Latin American growth converges to potential

Central banks will use interest rates and macroprudential measures to keep inflation within their medium term targets.

Inflation picks up across Asia

Food prices are the driver, with demand pressures and oil prices adding fuel to the fire.

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Markets

Oil prices soar on unrest in MENA region. But Libyan impact on supply is manageable

There are two main facts that make the oil market more sensitive to the protests in Libya than Egypt. Firstly, Libya produces 1.8mb/d while Egypt is just a thoroughfare for oil supply; the latter is just a matter of extra cost for alternative routes. Secondly, in Libya a pacific resolution seems less probable. However, OPEC spare capacity and OECD inventories could cover Libyan supply disruption. According to. US Department of Energy data from January, OECD stocks are estimated at 2719 million barrels. The lows of the last 5 years are around 2500 million barrels, so if Libyan supply were to be completely cut off (1.8mb/d), inventories would not hit low points until after 94 days. That is enough time to start up idle OPEC production capacity of more than 4.5mb/d. The location of this capacity is mainly in Saudi Arabia, accounting for 3.7mb/d, with a ramp-up period of less than 30 days. Compared with other historical oil disruptions, the market reaction to Libya seems too aggressive. Thus oil prices could be pricing in an extension of the conflict to other countries with a sizable portion of global supply.

Forex: Classic Risk Adverse Patterns – Sort Of

Ongoing tensions in the Middle East, and in particular Libya have given markets a reason to pause just as global growth emerges from the 2008-2009 credit crisis. Within the FX space, we have seen a classic move back towards risk adverse type trades with the CHF and JPY outperforming on a USD basis. This is different compared to price action during 2008-2009 when the market was purchasing USD's despite the notion that a lot of the crisis was due to issues grown in the US. Early days of the current crisis has the USD-index lower by circa 0.75% since the situation in Libya worsened over the weekend of February 18-19, -0.83%.

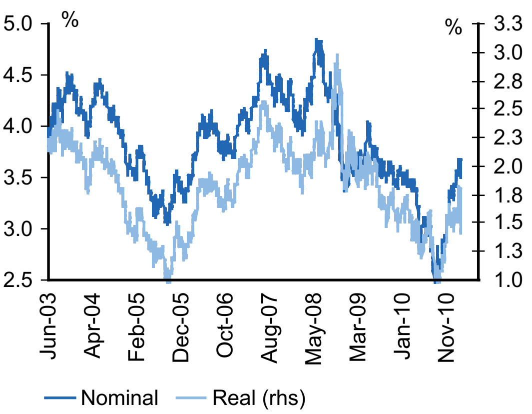
Generally, the market is still short of USD's across the board at extreme enough levels that we would expect most G10 currencies to not trend materially higher in the short-term, but a widening of the Middle East crisis to other oil-rich countries would compel us to re-examine our views.

Interest Rates: Decoupling between tranches – but is it sustainable?

The performance of the tranches of the German curve has been varied in recent days. On one hand, the key factor in the short term has been a maintained hawkish tone from the ECB council (Smaghi, Stark and Mersch). This has meant that both the monetary curve and 2Y tranches have been pushed up. We would note that the levels reached have not yet even breached the highs seen in January, suggesting sustained but not urgent concerns on the market about aggressive moves from the ECB. Meanwhile, rates at the long end of the curve have clearly been pushed down as a result of the rise in the geopolitical risk premium in the Middle East. We would also highlight that this drop in rates has occurred in both nominal and real curves, but has been more marked in the latter. As a result, inflation breakevens have widened (especially for 5Y tranches). This situation can be read in two ways: i) the market is reacting to systemic and cyclical risk, ii) which is compatible with a greater tendency to hedge against future inflation.

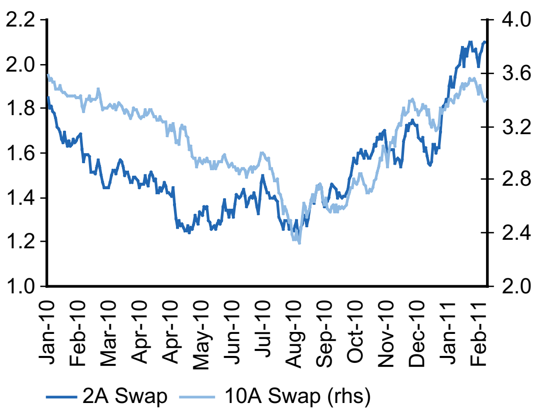
We do not think that this decoupling between tranches should last very long, and if the context of risk continues we would expect the long end to have a knock-on effect on the short end of the curve. Based on this outlook, the recent flattening of the 2/10Y slope (20bp since the start of the week) should lose some steam, and may even show signs of correcting.

Chart 3
France: Real and Nominal Rates 9/10Y



Source: Bloomberg and BBVA Research

Chart 4
Euro: 2Y and 10Y Swap Rates



Source: Bloomberg and BBVA Research

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Highlights

Unrest in MENA countries

Civil unrest in the Middle East has expanded to other MENA countries that have energy resources or where a peaceful resolution is less probable (Libya). This scenario is unlike the case of Egypt or Tunisia because of its higher level of uncertainty and has thus prompted an increase in geopolitical risk. Furthermore, the probability of this conflict spreading to Saudi Arabia has increased, which could in turn destabilize the whole region. The countries affected by conflict, so far, account for the 10% of world oil production. Thus financial strains have mainly been reflected in oil prices, although Saudi Arabia has announced that it will boost its oil production to meet the production short-fall left by Libya. The price of Brent crude has increased by 27% since the unrest in the Middle East started. Moreover, the upward trend has accelerated recently since Libya came onto the scene. Even though other risk indicators such as equity volatility or risky asset prices have not suffered a significant impact. Apart from this, the US dollar has not been bought as a safe haven asset, although there has been some flight to quality toward Swiss francs or US Treasuries. Accordingly, the US Ten-year bond yield has decreased by 15bps since the unrest started in Libya. Overall, the turmoil in the Middle East has not had a significant impact on the systemic risk premium, so far, but higher oil prices are pushing up inflation expectations and could hamper economic growth. Thus risk premieum will remain high.

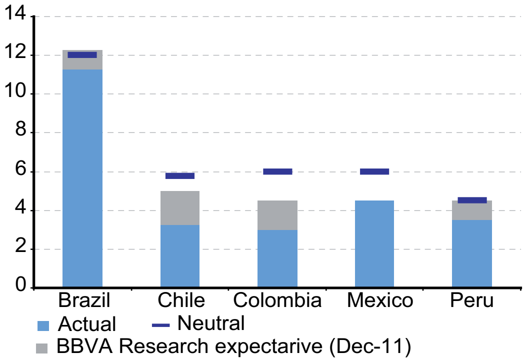
Latin American growth converges to potential

Our latest forecast for Latin America shows the region converging towards potential output growth on average (4.4% en 2011 and 4.0% in 2012). However significant differences emerge: while Venezuela and Argentina have been growing above potential for several years now, stoking inflationary pressures, Mexico and Colombia still have some room for growth, since actual GDP still has not reached capacity output. Brazil, Chile and Peru are in the middle, with output gaps becoming positive. Even though inflation remains subdued in most countries – Brazil is the main source of concern – and we expect it to remain close to targets over the year, policy makers have reacted to increasing concerns about overheating, resuming the pace of monetary tightening, after some pauses caused by fears of appreciation. We expect Central Banks in countries with explicit inflation targets will not risk losing their well deserved credibility, and will use interest rates, reserve deposits and other instruments to reign in liquidity and keep inflation within their medium term targets. By the end of the year, official interest rates should reach neutral levels in all these countries, as shown in the chart below. Currencies appreciation pressures would be smaller if fiscal policy contributes to moderate domestic demand expansion, as it is doing in Brazil now.

Inflation picks up across Asia

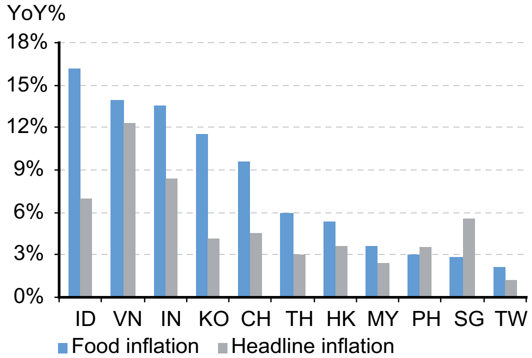
Inflation risks are mounting in Asia, with recent readings in most countries showing higher-than-expected trends. Food prices remain the main driver in most cases. The surge in food prices was caused by temporary supply shocks. However, strong domestic demand, abundant liquidity, and rising commodity prices have generated additional underlying pressures, with core inflation also picking up. Inflation readings in Singapore (5.5% y/y vs consensus: 4.4%) and Vietnam (12.3% y/y) released this week have underscored the extent of inflation pressures. To contain such pressures, policymakers have been tightening monetary policy along with a range of administrative measures. Subsidies could increase fiscal burdens, especially for countries with large deficits, such as India and Malaysia. However, food inflation has not been seen everywhere across the region. For instance, favourable weather in Taiwan and the Philippines, and the presence of subsidies on key staples in Malaysia, have helped to keep food price increases at bay in these economies. Though upside risks remain, we continue to believe that overall inflation levels should remain moderate given the awareness of policymakers and the actions being undertaken.

Chart 5
Latam: Official vs. Neutral Interest Rates (%)



Source: BBVA Research

Chart 6
Inflation in Asia



Source: BBVA Research

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Calendar: Indicators

Eurozone: Final HICP inflation (January, February 28th)

Forecast: 2.3% y/y	**Consensus:** 2.4% y/y	**Previous:** 2.2% y/y

Comment: Based on national figures already released, headline inflation is likely to have increased by 0.1pp to 2.3% y/y in January, below the flash estimation of 2.4% y/y. This coincides with our forecast before the flash was released and implies somewhat lower inflation pressures in the Eurozone. Underlying the increase should be slightly higher energy prices, while core inflation should have risen by 0.1pp to 1.2% y/y due to higher prices of processed food and non-energy industrial goods. In February, headline inflation is expected to accelerate further to around 2.4% y/y driven by commodities prices. According to our forecasts, annual inflation should reach a peak in Q1, but the recent increase in oil Brent prices pose an upside risk to this projection. **Market Impact:** A further acceleration in core inflation could increase market concerns about possible frontloaded tightening of monetary policy, as the ECB could react to avoid second round effects.

Eurozone: GDP (Q4 2010, March 3rd)

Forecast: 0.3% q/q	**Consensus:** 0.3% q/q	**Previous:** 0.3% q/q

Comment: We expect the second estimate of National Accounts for Q4 to confirm quarterly GDP growth of 0.3% q/q. In the breakdown by demand components, we see a positive contribution from net exports in Q4, as the slowdown in imports should have been more intense than that observed in exports, resulting in a contribution of around 0.1pp. Regarding domestic demand, our forecasts suggest that both private and public consumption could have increased further, while the construction component of investment could have been adversely affected by weather conditions. We have already seen this in the German data. **Market impact:** A negative performance by domestic demand beyond construction could increase concerns about the self-sustainability of the recovery.

US: Personal Income and Outlays (January, February 28th)

Forecast: 0.3%, 0.4% m/m	**Consensus:** 0.1%, 0.4% m/m	**Previous:** 0.4%, 0.7% m/m

Comment: In 2010 personal income and spending were stronger than previously expected and economic indicators suggest that this trend will continue in January. In the previous month personal income and spending jumped 0.4% and 0.7% m/m respectively, although some of this increase was due to an increase in prices. Additional fiscal stimuli and a less uncertain political environment after the elections boosted consumers' expectations. For example, consumer confidence has increased in the last five months and reached 70.4, its highest level since February 2008. Despite a labour market is weak, and although reduced housing wealth and tight credit conditions will continue to limit the pace of consumption growth, we expect recent trends in income growth and consumer optimism to continue pushing real PCE up in 1Q11. **Market impact:** A negative surprise in personal outlays would indicate a slowdown in PCE and raise questions about the sustainability of the recovery, while markets are already jittery due to increasing oil prices.

US: Nonfarm Payroll (February, March 4th)

Forecast: 185K	**Consensus:** 172K	**Previous:** 36K

Comment: : The unemployment rate continued to fall in January from 9.4% to 9.0%, its lowest level since March 2009. On the contrary, total and private non-farm payrolls rose only 36K and 50K, respectively. However, the release was blurred by significant revision to previous estimates due to annual benchmarking process, updating of seasonal adjustment factors and new population estimates and severe weather in the US. The labour force participation rate continued to decline and reached 64.2%, the lowest level since March 1984. The latest labour market indicators suggest that the US labour market has been improving at a slow pace and we expect stronger job creation in February compared to the previous month. **Market impact:** A significantly lower-than-expected February non-farm payroll would highlight continuing weakness in labour market conditions and decrease the probability of a fed funds rate hike in.

China: PMI (February, March 1st)

Forecast: 52.2	**Consensus:** 52.0	**Previous:** 52.9

Comment: The Purchasing Managers' Index (PMI) is expected to moderate further in February on the back of authorities aggressively tightening monetary measures. Since the beginning of this year, the PBoC has increased the benchmark interest rate by 25bp and raised the required reserve ratio (RRR) twice, 50bp each time, following a series of similar measures in 2010. Nevertheless, strong growth momentum will continue to keep the PMI outturn in the expansion zone (+50). Caution is needed in interpreting the January and February readings due to the seasonal impact of the Chinese New Year. **Market impact:** A higher-than-expected reading might create expectations of further tightening, with adverse market consequences, although such a reading might be discounted because of the seasonality effects noted above.

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				Close	Weekly change	Monthly change	Annual change
Interest Rates	(changes in bps)	US	3-month Libor rate	0.31	0	1	6
			2-yr yield	0.74	-1	11	-8
			10-yr yield	3.45	-13	3	-17
		EMU	3-month Euribor rate	1.09	1	4	44
			2-yr yield	1.55	15	23	59
			10-yr yield	3.16	-10	-3	6
Exchange Rates	(changes in %)	Europe	Dollar-Euro	1.375	0.6	0.5	1.1
			Pound-Euro	0.86	1.5	-0.8	-4.2
			Swiss Franc-Euro	1.28	-1.1	-0.8	-12.5
		America	Argentina (peso-dollar)	4.03	0.1	1.0	4.4
			Brazil (real-dollar)	1.66	-0.1	-0.5	-7.9
			Colombia (peso-dollar)	1893	0.9	1.6	-1.7
			Chile (peso-dollar)	476	1.6	-2.6	-9.3
			Mexico (peso-dollar)	12.12	0.8	0.6	-5.1
			Peru (Nuevo sol-dollar)	2.78	0.3	0.1	-2.6
		Asia	Japan (Yen-Dollar)	81.75	-1.7	-0.8	-8.0
			Korea (KRW-Dollar)	1126.38	1.4	0.9	-2.5
			Australia (AUD-Dollar)	1.014	0.0	2.0	13.5
Comm.	(chg %)		Brent oil ($/b)	111.9	9.2	14.3	44.2
			Gold ($/ounce)	1405.6	1.2	4.4	25.8
			Base metals	612.2	-0.5	1.4	25.9
Stock Markets	(changes in %)	Euro	Ibex 35	10828	-2.2	1.5	4.8
			EuroStoxx 50	2983	-2.8	0.5	9.3
		America	USA (S&P 500)	1314	-2.1	1.4	19.0
			Argentina (Merval)	3420	-3.3	-6.1	54.0
			Brazil (Bovespa)	67391	-1.0	-1.9	1.3
			Colombia (IGBC)	14576	3.2	-3.5	24.3
			Chile (IGPA)	20963	-1.6	-8.5	17.8
			Mexico (CPI)	36447	-2.9	-3.0	15.2
			Peru (General Lima)	22608	-1.9	2.7	61.5
			Venezuela (IBC)	67722	1.8	2.5	20.6
		Asia	Nikkei225	10527	-2.9	1.2	4.0
			HSI	23012	-2.5	-3.5	11.7
Credit	(changes in bps)	Ind.	Itraxx Main	102	6	3	18
			Itraxx Xover	405	23	-1	-59
		Sovereign risk	CDS Germany	54	1	-5	12
			CDS Portugal	477	22	27	312
			CDS Spain	272	23	2	136
			CDS USA	47	0	-1	---
			CDS Emerging	233	15	31	-35
			CDS Argentina	681	66	138	-469
			CDS Brazil	121	6	11	-9
			CDS Colombia	123	5	12	-34
			CDS Chile	82	4	3	8
			CDS Mexico	118	3	5	-9
			CDS Peru	117	6	10	-15

Source: Bloomberg and Datastream

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