Weekly Watch
Global

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Economic Analysis

Financial Scenarios
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Growth slowdown in the spotlight

Economic data this week suggested that the EZ activity is slowing down in the current quarter, in line with our expectations, while in the US the composition of Q1 growth was less encouraging (less private consumption and more inventory building) at the same time when there are increasing signs pointing at a milder than expected rebound in Q2. The EZ PMI composite fell more than expected in May to 55.4 (from 57.1), mainly driven by manufacturing, but the service sector also slowed. Meanwhile, the second estimate of Q1 GDP growth was unchanged (below expectations) at 1.8% (q/q annualized). Additionally, the slight upward trend seen in the US jobless claims points out to a less supportive labour market. The pace of economic activity is also showing some signs of moderation in LatAm in 2Q11. The contraction in the Japanese economy is taking a toll on Mexican manufacturing activity, while retail sales and unemployment data are consistent with a moderation in domestic demand.

Greece makes additional efforts

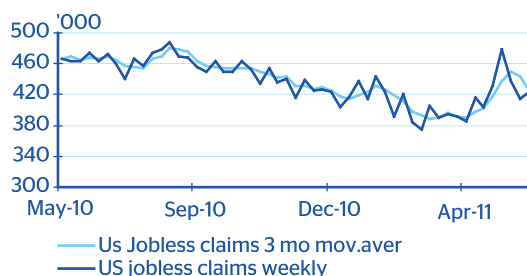
The Greek government has announced an additional EUR6.4bn of measures to achieve the fiscal target for 2011. Moreover, the 2012-2015Medium-Term Fiscal Strategy (MTFS) is also being debated by the Greek Cabinet. The government has also given some details of the expected privatization program (considered the cornerstone of the program). The Parliament should reach an agreement on these measures no later than early June in order to get an aid package from the EU and the IMF. In or view. The most likely option in the short term is that IMF+EU will extend their financial support to Greece with strict conditions.

ECB officials call for interest rates normalization

EZ rate hike expectations for 2011 have moderated recently on the view that sovereign risk will govern ECB decisions. However, in contrast with recent movements in the market's expectations, comments from ECB officials (most importantly Draghi) have remained on the hawkish side, validating their pre-emptive approach ("...there is a greater need to proceed with monetary-policy normalization").

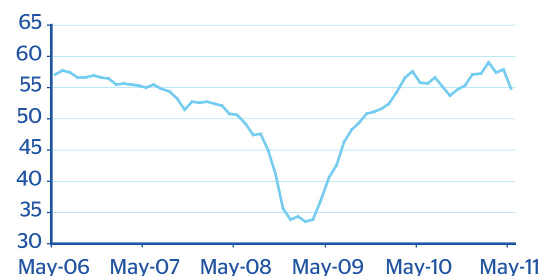
Next week: In the US, April payroll figures and May ISM Manufacturing will give further clues about the degree of moderation. While in the EZ, the May flash HCPI will catch market's attention.

Chart 1
US Jobless claims



Source: Bloomberg

Chart 2
Eurozone Manufacturing PMI



Source: Bloomberg

Markets →
Highlights →
Calendar →
Markets Data →

Highlights

Japan: despite disappointing post-quake data, a strong rebound is underway
The Japanese economy continues to adjust in the aftermath of the March 11 earthquake.

LatAm countries have some room for manoeuvre to limit risk
Central Banks are stepping up efforts to curb inflation risk, while the ample currency reserve and fiscal savings could lessen the impact of oil prices.

Rating Agencies are quite active on sovereign debt
CDS prices for European countries suggest that financial markets foresee more credit downgrades.

Markets Analysis

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Markets

Sovereign and cyclical risk remain the key drivers

Currencies

Trends in the global forex market over the last week were driven by sovereign and cyclical risk premiums. Despite the budgetary cuts announced by Greece at the start of the week, uncertainty over the possibility of debt restructuring persists. Meanwhile, economic indicators surprised on the downside, mainly the US figures, thus sustaining the concerns with regard to the global economic cycle. The bias on the forex market was therefore towards risk aversion, leading to high volatility in both core and emerging currencies. In all, the factor which had the greatest impact was the downside surprises in US growth, triggering fresh depreciation of the USD vs. other core currencies. In fact, safe haven and funding currencies appreciated (0.3% in the case of the JPY) while most emerging currencies were more volatile and depreciated. After attempting to breach the 1.40 zone (which we still consider to be a key support, since most of the closing of non-commercial positions on the CFTC has already taken place) EUR closed the week with no significant changes.

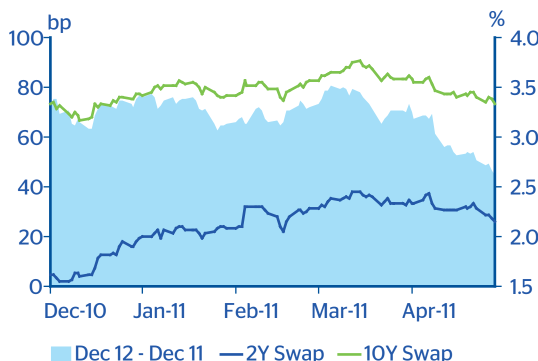
Interest rates

Euro curves have corrected downward quite significantly in recent days. This not only confirms that transitory nature of the rises in rates in previous weeks, as we anticipated, but is also significant because it has had more of an impact on the short end in comparative terms. The 2Y swap has corrected by around 18bp since last week (the 10Y has only corrected 8bp). We would also highlight the correlation between this greater movement at the short end and the downward bias of Euribor 3M futures, above all at the long end (flattening). In just 6/8 days the Dec 12 contract has corrected by 30bp and is now at 2.30%, a level not seen since January. This profile partially reflects the fact that the market is assigning less room for ECB rate hikes in the medium term, in the midst of a phase of imminent risk of restructuring of Greek debt. In addition, the recent deceleration in cyclical data is also contributing to this more conservative outlook being priced into the curves.

Equity

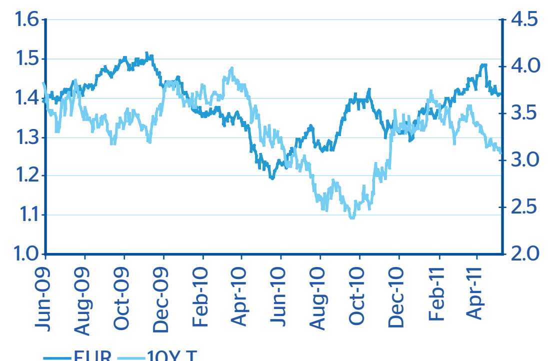
Since the start of the month the Eurostoxx has accumulated a fall of around 6%, led by the Financial sector and industries linked to commodity prices, against a backdrop of a 25bp drop in the IRR of the 10Y German bond. All other things being equal, this implies theoretical tightening of the equity risk premium of clearly more than 50bp, reflecting some risk aversion on equity markets (which could increase if the yield of the 10Y Bund breaches 3%). Macro data remains a key factor in the short term – cyclical and sovereign risk form a vicious circle – together with the strategy for unwinding QE2, the upcoming European banking stress tests, and the decision with regard to the cap on US debt. Consensus EPS estimates remain sound (even though they are a lagging indicator of expectations for the cycle) and our long-term outlook is still positive, since we are convinced of the strength of the global cycle and confident that a reasonable solution will be found for the European sovereign risk issue. However, we are somewhat more cautious with regard to the short term, regardless of the possibility that the current rally could last a little Langer.

Chart 3
Slope of curve for 3M Euribor futures (Dec 2012 - Dec 2011) vs. 2Y and 10Y Swap



Source: Bloomberg

Chart 4
EUR and 10YT: cyclical and sovereign risk favour high correlation



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Home
Highlights
Calendar
Markets Data

Economic Analysis

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Highlights

Japan: despite disappointing post-quake data, a strong rebound is underway

The Japanese economy continues to adjust in the aftermath of the March 11 earthquake. April exports were down by -12.7% y/y and retails sales declined by -4.8% y/y. The data follow similar plunges in March, as supply disruptions —especially in the auto sector— and weak consumer and business confidence take their toll. Q1 GDP growth surprised on the downside (-3.7%, q/q saar vs. consensus: -2.0%), confirming a technical recession (two consecutive quarters of negative growth). However, the impact of the earthquake on full-quarter GDP was probably small since the earthquake occurred toward the very end of the quarter, meaning that underlying growth momentum may have been weaker than previously anticipated. Nevertheless, there is good reason to expect a rapid rebound during the second half of the year, as incorporated in our 2011 full-year growth projection of 0.5%. Evidence suggests that a resumption of supply chains may occur faster than previously expected, and consumers may already be returning to more normal spending patterns. It is also noteworthy that the weak Q1 GDP outturn was due to a drawdown of inventories. As supply chains are restored, a rebuilding of inventories would likely contribute to a rebound in activity, over and above the boost from reconstruction spending. The Bank of Japan (BoJ) kept its monetary stance unchanged at its most recent meeting on May 20, after unveiling an initial round of stimulus policies just after the quake. We expect the BoJ to implement additional schemes to facilitate recovery. These may well include an expansion of the asset-purchase program from the current JPY10 trillion and boosting the JPY3 trillion special lending facility. We also expect the government to approve further spending, but the room for manoeuvre is limited due to the high public debt.

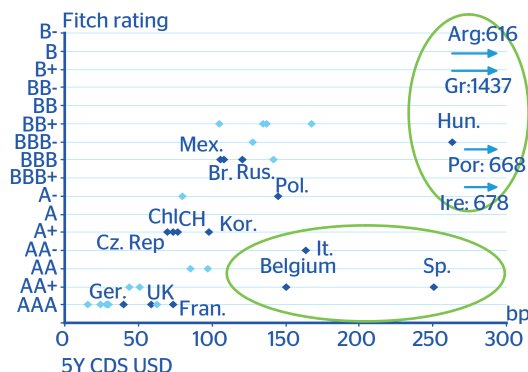
LatAm countries have some margin of manoeuvre to limit risk

We expect an orderly de-acceleration of Latin American growth in 2011-12, towards 4.5% p.a.. Even though inflation remains a risk, Central Banks regained their footing after some initial hesitation, and now are fast withdrawing the monetary stimuli. A few countries (Brazil, Chile) are also introducing some fiscal tightening. One outstanding feature of this recovery is the significant increase in investment ratios across the region, both a reflection of a better business climate and a condition to support future growth. FDI is playing a major role in this expansion. The region also kept public and external debts in check, (they are still falling as a fraction of GDP) while current account and fiscal deficits remain very small. Our view is that most of the countries in the region would be able to withstand a major correction in commodity prices, using their ample reserves and fiscal savings to finance a smooth adjustment. This is a very hard to beat combination of growth opportunities with limited risks, but a discriminatory eye is needed.

Rating Agencies, quite active on sovereign debt

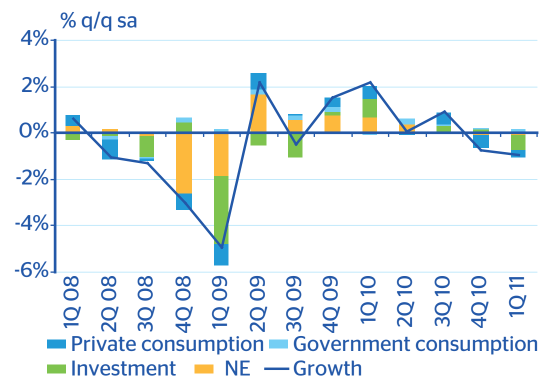
Rating agencies have been very active in reviewing European sovereign credit ratings nowadays. The combination of high public deficits, high levels of indebtedness, ramping financial costs, and low economic growth have led credit agencies to downgrade the outlook of a large number of European countries credit ratings. For instance, over the past week, Standard & Poor's has downgraded Italian debt's outlook to negative from stable, while Fitch has cut Belgium's outlook to negative from stable. Rating agencies' movements tend to be behind the curve and this time is not the exception. As we can see in the chart below, European peripherals have a significantly higher cost of insuring against default than other countries with lower credit ratings. In the case of Spain and Italy both countries have single A credit ratings assigned by Fitch, but their 5Y CDS prices are 251bp and 164bp, respectively. Meanwhile, the Mexican and Brazilian 5Y CDS prices stand at 106bp and 108bp, respectively, even though Mexico and Brazil are rated BBB by Fitch. Overall, these high CDS prices for European countries suggest that financial markets foresee potential for further downgrades, unless governments step up measures.

Chart 5
Sovereign Rating vs 5Y CDS USD



Source: Bloomberg

Chart 6
Japan's GDP and Activity Plunge after the Earthquake



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Home
Markets
Calendar
Markets Data

Economic Analysis

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Calendar: Indicators

Eurozone: HICP inflation (May, May 31st)

Forecast: 2.8% y/y	Consensus: 2.8% y/y	Previous: 2.8% y/y

Comment: After seasonal effects in previous months, we expect headline inflation to remain relatively stable at 2.8% y/y in May. In addition, fuel prices in recent weeks have continued to moderate, putting some downward pressure on our forecasts, although we think that they should be partly offset by upward risks coming from higher indirect effects. The detailed breakdown will not be released next week, but our projections show that core inflation could have also remained virtually stable at 1.8% y/y. **Market Impact:** A further acceleration in core inflation could increase market concerns about greater indirect effects, that could result in a tighter monetary policy in order to avoid both second-round effects and the de-anchoring of inflation expectations.

US: ISM Manufacturing Index (May, June 1st)

Forecast: 59.0	Consensus: 58.0	Previous: 60.4

Comment: The ISM manufacturing index declined slightly from 61.2 to 60.4 in April and remained above 60% for the fourth consecutive month. The ISM Prices Index increased for the fifth consecutive month, consistent with an increase in consumer prices and energy prices. We expect the ISM manufacturing index to remain above 55, indicating ongoing improvement in economic activity. **Market impact:** An increase in the ISM manufacturing index would surprise financial markets, eliminate some of the pessimism about the pace of the recovery and increase stock prices.

US: Nonfarm Payroll (May, June 3rd)

Forecast: 210K	Consensus: 195K	Previous: 244K

Comment: Non-farm payrolls increased by 244K while the unemployment rate climbed to 9.0% in April. Most of the service-providing industries, manufacturing, and mining sectors created new jobs and the private sector added 268K new jobs in April. Of the 268K jobs created in the private sector, 224K came from private service-providing sectors while temporary help services declined, illustrating that some private companies could become more willing to commit to hiring permanent employees. On the other hand, the number of unemployed people increased by 205K on a seasonally adjusted basis and pushed the unemployment rate up, which is also consistent with recent increase in initial jobless claims. We expect the US economy to have created 210K new jobs in May but the unemployment rate remained at 9.0%. **Market impact:** If non-farm payrolls in May are significantly lower than expected, it would imply a slowdown in hiring and economic activity in 2Q11 and bring down equity prices.

China: PMI for (May, June 1st)

Forecast: 51.9	Consensus: 51.6	Previous: 52.9

Comment: We expect the Purchasing Managers' Index (PMI) to ease further in May following a number of recent activity indicators pointing to moderation in growth. A moderating trend in the PMI would be welcome news for the authorities who have been seeking to contain inflation and prevent overheating through monetary tightening. While some market participants have expressed fear of a hard landing, the PMI should remain well within the 50+ expansion zone, indicating a soft landing. **Market impact:** A reading in line with or below consensus is likely to exacerbate market fears of a hard landing in China**.**

Brazil: GDP (First quarter, June 3rd)

Forecast: 1.1%q/q	Consensus: 1.2%q/q	Previous: 0.7%q/q

Comment: GDP remained strong in the first quarter. It should have accelerated with respect to 4Q10 when it expanded 0.7%q/q. A moderation of the private consumption and an acceleration of investments are expected in comparison to Q4. In yearly terms, growth should drop from 5.0%y/y in Q4 to slightly more than 4.0%y/y. **Market Impact:** We see room for GDP surprising markets on the upside, but the focus will be on growth composition: if private consumption refrains from moderating as expected, extra pressure will be put on future interest rates and on inflation expectations..

Home

Markets

Highlights

Markets Data

Markets Data

			Close	Weekly change	Monthly change	Annual change
Interest Rates (changes in bps)	US	3-month Libor rate	0.25	0	-2	-28
		2-yr yield	0.48	-3	-16	-28
		10-yr yield	3.06	-9	-30	-23
	EMU	3-month Euribor rate	1.43	-1	6	73
		2-yr yield	1.57	-20	-24	105
		10-yr yield	2.97	-9	-32	29
Exchange Rates (changes in %)	Europe	Dollar-Euro	1.423	0.2	-3.1	15.4
		Pound-Euro	0.86	-1.0	-2.6	1.7
		Swiss Franc-Euro	1.22	-2.2	-5.5	-14.5
	America	Argentina (peso-dollar)	4.09	0.0	0.2	4.4
		Brazil (real-dollar)	1.61	-0.4	2.3	-11.8
		Colombia (peso-dollar)	1820	-0.2	2.2	-7.8
		Chile (peso-dollar)	468	0.1	1.2	-11.9
		Mexico (peso-dollar)	11.63	0.1	0.5	-9.8
		Peru (Nuevo sol-dollar)	2.75	-0.3	-2.9	-3.5
	Asia	Japan (Yen-Dollar)	81.00	-0.8	-1.8	-10.8
		Korea (KRW-Dollar)	1082.45	0.0	0.5	-11.2
		Australia (AUD-Dollar)	1.068	0.1	-1.2	26.3
Comm. (chg %)		Brent oil ($/b)	115.2	2.5	-8.0	55.6
		Gold ($/ounce)	1532.2	1.3	0.3	26.2
		Base metals	606.4	-0.1	-2.1	26.0
Stock Markets (changes in %)	Euro	Ibex 35	10270	0.4	-4.4	9.0
		EuroStoxx 50	2817	-1.3	-5.4	7.7
	America	USA (S&P 500)	1331	-0.2	-1.8	22.1
		Argentina (Merval)	3272	-3.3	-3.1	50.9
		Brazil (Bovespa)	64264	2.7	-3.0	3.7
		Colombia (IGBC)	14424	2.1	1.4	18.0
		Chile (IGPA)	22992	0.8	2.1	28.3
		Mexico (CPI)	35810	1.4	-2.8	13.5
		Peru (General Lima)	22688	4.0	26.3	56.4
		Venezuela (IBC)	80077	1.3	9.0	29.7
	Asia	Nikkei225	9522	-0.9	-1.8	-2.5
		HSI	23118	-0.4	-3.2	17.0
Credit (changes in bps)	Ind.	Itraxx Main	103	3	5	-15
		Itraxx Xover	372	11	11	-184
	Sovereign risk	CDS Germany	40	1	-4	-1
		CDS Portugal	678	39	11	368
		CDS Spain	253	-7	1	37
		CDS USA	50	-1	5	---
		CDS Emerging	219	12	12	-58
		CDS Argentina	613	16	15	-593
		CDS Brazil	108	6	-1	-29
		CDS Colombia	104	5	3	-58
		CDS Chile	70	5	10	-35
		CDS Mexico	105	5	4	-32
		CDS Peru	127	-5	-45	-7

Source: Bloomberg and Datastream

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