

Global

# Weekly Watch

Madrid, 2 July 2010

## Economics Analysis

Financiacial Scenarios

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## Renewed doubts about the resilience of the recovery

New macro data releases from the US, particularly on the labor market and consumer confidence, and the Chinese PMI for June helped to raise market concerns about a scenario of weaker growth or even a double-dip. The data flow is still consistent with our forecasts for the US and China, which do not anticipate a marked slowdown. However, uncertainty is increasing and since our figures are below market consensus in all major economies it is quite likely that negative surprises continue as markets adjust their overstretched growth expectations.

### All eyes on Europe,...

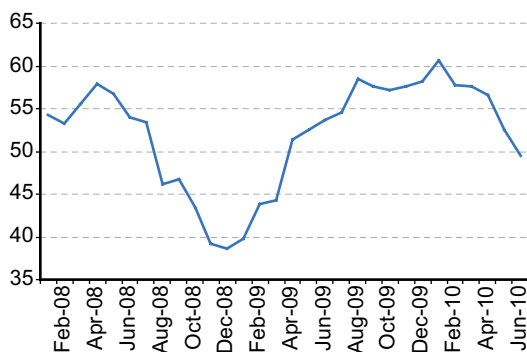
In Europe, Germany's industrial production and exports for May and the Eurozone's retail sales for the same month might confirm next week if this trend also applies for the old continent. The ECB meeting will also be at centre stage next week. We do not expect any major change, but there will be a strong demand for explanations regarding liquidity policies.

### ...although China's exports might also add further uncertainty

Following the negative surprise in June's PMI, a lower-than-expected export data could intensify the renewed market concerns of a hard landing in China. Nonetheless, we see downward risks to the Chinese economy as more limited than markets are currently pricing.

Chart 1

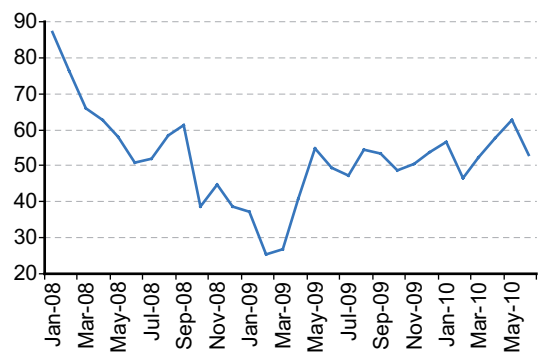
**China: Manufacturing PMI (index)**



Source: Datastream and BBVA Research

Chart 2

**USA: Consumer confidence index**



Source: Datastream and BBVA Research

## Highlights

Markets



### ECB's liquidity policies and the implication for Eonia

After the limited amount demanded by banks in June's three month auction, it is expected that liquidity in the Euro area will be much lower. This could move Eonia fairly quickly towards 1%, and the ECB will need to communicate that this is only a normalization of rates, not a change in stance.

Highlights



Calendar



### Decoupling in M&A activity gives support to emerging currencies

In the last two months, annual accumulated M&A inflows to emerging countries have almost reached the pre-crisis peak, adding an element of support to the appreciation of their currencies.

Markets Data



### Strong credit growth in LatAm points to further monetary tightening

Recent data showed that bank credit is growing strongly in the region. Brazil's adjustment in the reserve requirement ratio was expected, but risks are biased to earlier tightening if credit surprises continue.

Markets Analysis

Markets

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**Liquidity auctions stabilise financial risk in Europe**

The ECB's liquidity auctions and the weak cyclical indicators are the two factors which have determined financial market trends this week. Although unaggressive demand in liquidity auctions has involved a rise in EONIA rates in line with forecasts, it is important because it has stabilised, or at least eased financial risk in Europe. As a result, the disappointing economic releases in the US are not affecting all assets equally: those linked to the dollar are suffering the most.

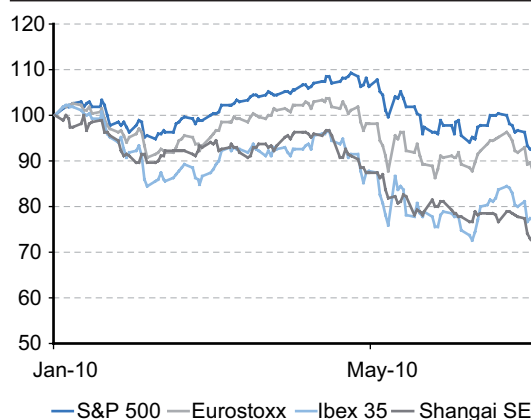
**Weaker fundamentals for the USD, slightly stronger for the EUR**

During the last few days there has been a slight change in the perception of global and regional risks. On the one hand, macro data in the US and China continue losing gas. On the other, the risk perception in the Euro Zone is decreasing: the unaggressive demand in the ECB's 3M auction has been positive because it reduces the perception of an unstable financial system. This has had a clear impact on exchange rate crosses: i) it has given rise to a certain change in the market positioning (not so aggressively short euros and long dollars). The USD could now be more exposed to US macro data (especially with regard to its crosses with OECD currencies); ii) the JPY and CHF remain the strongest currencies (though there are growing signs that this movement is coming to an end in the short term); iii) in the EURUSD, this situation has allowed for a return to the upper end of the range (EURUSD 1.25), though no further rises are expected; iv) this factor is also weighing on the LatAm currencies which are more closely linked with the USD: the MXN is suffering the most and is already above 13 vs. USD, whereas the BRL is supported by local factors (further monetary tightening) and remains firm at around 1.80.

**Cyclical risk will not treat all stock markets equally**

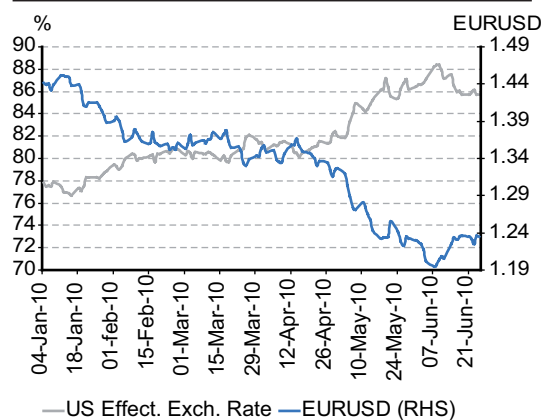
Markets have begun to price in an increase in cyclical risk. The disappointing economic releases have raised uncertainties regarding corporate earnings growth. In our view, cyclical risk will mostly affect the regions whose recent stock market performance has been closely connected with the economic recovery worldwide. In this regard, Chinese equities, down 28% YTD, or the Ibex35, down 23% YTD, have already priced in a cyclical slowdown and therefore should not be hit as hard as the rest of emerging markets or European equities. However, the Spanish market's performance will continue to be driven by banking sector news and sovereign risk, and we expect the Ibex35 relative performance to remain negative medium term.

Chart 3  
**Performance of main stock market indices**



Source: Datastream

Chart 4  
**EURUSD vs. USD Effective Exchange Rate**



Source: Bloomberg

Economics Analysis

Highlights

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**ECB's liquidity policies and the implication for Eonia**

The ECB announced this week the results of the June's 3M LTRO with full allotment. The funds allotted were € 132 bn, with a total number of bidding institutions of 171. The amount is clearly more than what had been given in recent auctions, but is still less than 1/3 of the € 442bn that also expired this week. The implication for EONIA and short-term liquidity conditions in the Euroarea will primarily depend on how much liquidity will remain in the system after this week's maturity. Since the fall in liquidity (around € 170bn) matches the average use of the deposit facility (€ 170bn) since July 2009, this result suggests that almost all the extra-liquidity that was available during the last year will disappear as consequence of this week's maturity. This corroborates our view that the 12-month maturity could press Eonia upwards fairly quickly towards 1%. Nonetheless, as sovereign debt concerns maintain a strong hoarding motive in bank's liquidity policies we do not expect this impact to be immediate.

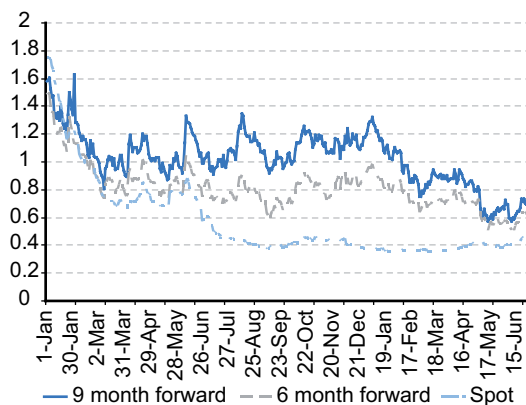
**Decoupling in M&A activity gives support to emerging currencies**

Since the second half of 2009, M&A activity around the world is showing the same decoupling between developed and emerging countries evidenced in other markets. In the last two months, annual accumulated M&A inflows to emerging countries, basically Asia and Latin America, have almost reached the pre-crisis peak, while in developed countries M&A remains at 10-year minimums. Empirical regularities point to M&A flows having a medium term impact on currencies, supporting our view of appreciation pressures for emerging currencies going forward. We expect this diverging pattern of M&A flows to continue in the months to come, as the growth gap between advanced and emerging economies will continue.

**Strong credit growth in LatAm points to further monetary tightening**

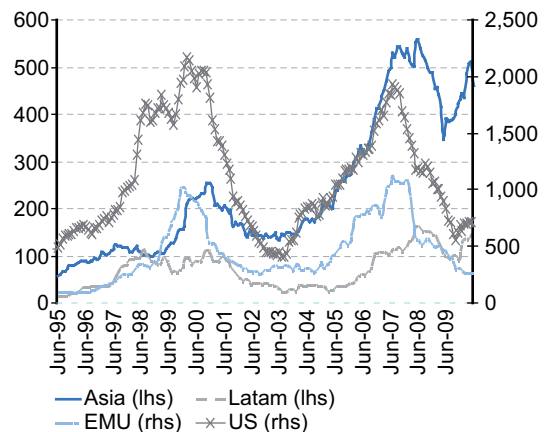
Recent data from Brazil and Peru showed that bank credit is growing at an impressive pace and fuelling strong growth in the whole region. The outstanding loans in Brazil's banking system rose by 2.1% m/m in May. In Peru, last month's data also showed strong credit growth after reaching the highest level since October 2008 (+10% y/y), supported by very favorable economic and financial conditions. This flow of funds is putting additional pressure to domestic central banks for further tightening. In fact, the Brazilian Central Bank has recently announced it will gradually elevate its reserve requirement ratio (RRR) from 42% to 45% in an attempt to curb economic growth and control inflation expectations. The adjustment in RRR and other monetary measures are in line with our view that regional policy makers will try to make use of different tools, but risks would tilt to earlier hikes if surprises in activity and credit continue.

Chart 5  
**OIS 3 month rates implicit in OIS swaps**



Source: Datastream and BBVA Research

Chart 6  
**M&A inflows to selected areas (annual accumulated, in \$ bn)**



Source: Thomson Financial and BBVA Research

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## Calendar: Indicators

## USA: Consumer Credit (April, July 8th)

Forecast: **-\$1.9bn**                      Consensus: **-\$2.0bn**                      Previous: **\$1.0bn**

**Comment:** Consumer credit outstanding is expected to have declined further in April, yet the overall pace should slow. **Market Impact:** This is a lagged indicator that does not have a large market impact. Nevertheless, a negative surprise in this front could indicate that the pace of recovery of consumer spending will be limited by lack of the use of credit.

## USA: ISM Non-Manufacturing Index (June, July 6th)

Forecasts: **55.4**                      Consensus: **55.4**                      Previous: **55.4**

**Comment:** Non-manufacturing economic activity will expand for the fifth consecutive month in June, but at the same speed as the prior three months. While expansion is a good sign for employment, the stagnant pace supports our expectation of a slow labor market recovery. **Market Impact:** A negative surprise could indicate that the economy is losing some steam, which would limit the speed of job growth even further.

## Germany: Exports (May, July 8th)

Forecasts: **3.1% m/m**                      Consensus: **4.0% m/m**                      Previous: **-6.3% m/m**

**Comment:** After the sharp fall in April, German exports are expected to rise again in May, as assessments of exports order books from EC survey continued to improve in May and June. **Market Impact:** A negative surprise could be very damaging as exports are the main driver of the economic recovery.

## Eurozone: Retail sales (May, July 5th)

Forecast: **0.7% m/m**                      Consensus: **0.5% m/m**                      Previous: **-1.5% m/m**

**Comment:** Retail sales are expected to increase slightly in May, but below Q1 figures when private consumption remained virtually stalled. In this regard, May's figures are in line with our view that the rebound of activity expected for Q2 will be supported by net exports instead of consumption. **Market Impact:** A negative surprise could be interpreted as another sign of weakness and fragility that could be very damaging for global markets.

## Mexico: CPI (June, July 8th)

Forecast: **0.0% m/m**                      Consensus: **0.1%**                      Previous: **-0.6%**

**Comment:** June should register the first "non-decrease" in CPI after two months of falls, pushed by non-core and processed food items. All in all, the inflation rate is expected to slow from 3,9% to 3,7%. **Market Impact:** Negative surprises in inflation have been one of the drivers behind the evolution of the yield curve over the last two months. Our scenario foresees and upward trend on inflation across H210. An early positive surprise, however, could have an upward impact in the yield curve, particularly if global factors are biased to risk aversion.

## China: Export growth (June, July 10th)

Forecast: **31.0%**                      Consensus: **37.0%**                      Previous: **48.5%**

**Comment:** After May's surprisingly high outturn, we expect exports to slow in June, on weaker external demand and the recent removal of the export tax rebate. **Market Impact:** Following the lower-than-expected PMI reading for June, underpinned by a weaker export orders subcomponent, a sluggish export outturn could intensify concerns of a sharp slowdown in China. This would also further reduce expectations of the magnitude of currency appreciation.

Table 1

**Market data**

		<b>Close</b>	<b>Weekly change</b>	<b>Monthly change</b>	<b>Annual change</b>	
<b>Interest rates</b> (changes in bps)	<b>US</b>	3-month Libor rate	0.53	0	0	-3
		2-yr yield	0.63	-2	-18	-35
		10-yr yield	2.96	-15	-41	-54
	<b>EMU</b>	3-month Euribor rate	0.79	4	8	-27
		2-yr yield	0.67	10	17	-57
		10-yr yield	2.59	-2	-9	-75
<b>Exchange rates</b> (changes in %)	<b>Europe</b>	Dollar-Euro	1.259	2.0	3.4	-10.0
		Pound-Euro	0.83	0.7	-0.5	-3.2
		Swiss Franc-Euro	1.34	-0.9	-4.9	-11.8
	<b>America</b>	Argentina (peso-dollar)	3.93	0.1	0.3	3.5
		Brazil (real-dollar)	1.78	0.1	-2.2	-8.8
		Colombia (peso-dollar)	1896	-0.2	-3.4	-9.3
		Chile (peso-dollar)	539	0.3	0.4	-0.1
		Mexico (peso-dollar)	13.07	3.0	2.0	-1.4
		Peru (Nuevo sol-dollar)	2.82	-0.1	-0.8	-6.4
		Japan (Yen-Dollar)	87.70	-1.8	-5.0	-8.6
	<b>Asia</b>	Korea (KRW-Dollar)	1226.31	1.4	0.9	-3.4
		Australia (AUD-Dollar)	0.846	-2.8	0.9	6.2
	<b>Comm.</b> (chg %)	Brent oil (\$/b)	72.3	-7.5	-4.2	10.2
		Gold (\$/ounce)	1201.8	-4.3	-0.4	28.9
Base metals		473.4	-1.9	0.0	16.4	
<b>Stock markets</b> (changes in %)	<b>Euro</b>	Ibex 35	9408	-1.3	1.4	-3.1
		EuroStoxx 50	2551	-3.0	-3.2	7.3
		USA (S&P 500)	1026	-4.7	-6.9	14.5
	<b>America</b>	Argentina (Merval)	2209	-4.7	-1.3	39.9
		Brazil (Bovespa)	61127	-5.7	-2.9	20.0
		Colombia (IGBC)	12389	-1.1	0.5	24.1
		Chile (IGPA)	18739	-1.7	3.2	26.1
		Mexico (CPI)	31355	-3.8	0.1	30.4
		Peru (General Lima)	13866	-2.3	-1.9	7.5
		Venezuela (IBC)	65176	0.1	3.0	46.0
		<b>Asia</b>	Nikkei225	9204	-5.5	-7.2
	HSI		19905	-3.8	0.6	9.3
	<b>Credit</b> (changes in bps)	<b>Ind.</b>	Itraxx Main	131	4	11
Itraxx Xover			585	36	26	-153
<b>Sovereign risk</b>		CDS Germany	44	-1	1	11
		CDS Portugal	306	-18	-25	239
		CDS Spain	262	12	9	181
		CDS USA	37	-1	-2	---
		CDS Emerging	276	20	3	-113
		CDS Argentina	1002	36	-124	-998
		CDS Brazil	142	11	8	-36
		CDS Colombia	152	3	-6	-54
		CDS Chile	105	6	5	-25
		CDS Mexico	139	11	8	-69
		CDS Peru	138	10	5	-44

Sources: Bloomberg, Datastream and JP Morgan

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