

Global

Weekly Watch

Madrid, 30 July 2010

Economics Analysis

Financial Scenarios

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Financial tensions recede giving sovereigns a break

Recent data, as the drop in consumer confidence in July (for the 2nd consecutive month) and in durable goods orders in June, and Fed's Beige Book keep on remarking the weaker-than-expected US recovery, while in Europe the releases are still better than expected, as most of EMU countries had improvements in confidence with Germany showing the most significant increase. However, the main news this week is the easing in financial tensions. Next week there are the ECB and BoE meetings, we do not anticipate major changes, but we will monitor the Q&A after the ECB gave signs of normalization laying out tougher lending rules today.

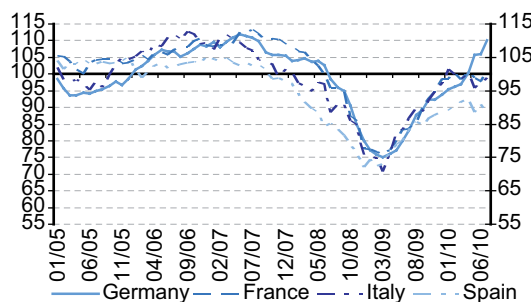
Sovereign risk premiums are reduced in peripheral Europe...

Financial tensions eased from their highs in May strongly promoted by the publication of European stress test results, especially for Spain for which the exercise has been differentially wide and credible, and it is undertaking a strong fiscal adjustment. However, risk premiums are still high in most vulnerable countries and the real watershed will be the re-opening of funding markets as in the coming months they face a large amounts of debt maturing.

... and the monetary tightening cycle continues in Asia

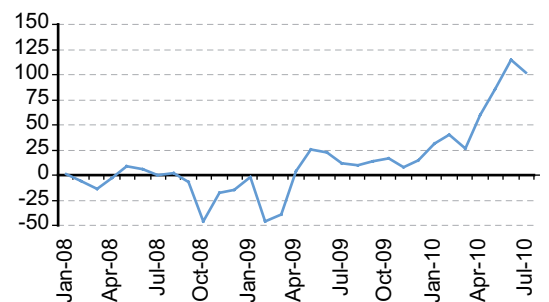
Increasing signs of rising inflation in Asia call for further monetary tightening, as shown by India's decision to raise again its official rates. Next week, the releases of inflation data in several Latin American countries will give us hints of how will the pace of policy normalization continue in that region.

Chart 1
**EC Survey:
economic sentiment by country**



Source: European Commission Survey

Chart 2
**Spain: Degree of market
overvaluation in country risk indicators**



The line depicts the spread between the current value (CDS 5Yr Sov.) and structural CDS derived (Estimate through an econometric model based on fundamentals).
Source: BBVA Research

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Positive events for the banking system: European Stress Tests and Basel agreement

The results of the EU-wide stress test exercise revealed a strong resilience of the Spanish Banking system. Also this week the Basel Committee on Banking Supervision finally reached an agreement on the capital and liquidity reform package.

Is it too soon to pull back the fiscal stimulus in developed countries?

As recent data increasingly shows that the recovery will remain subdued in developed countries, there is a renewal debate about the pros and cons of early fiscal retrenchment.

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Gradual re-opening of the credit market after the stress test

Credit markets continued to improve this week especially in non-core countries after the publication of stress test results, with Portugal and Spain taking the lead and easing somewhat (the Spanish sovereign debt continued to significantly narrow for the third week in a row). Hints of a gradual re-opening of credit markets led by the two large Spanish banks, which issued senior debt after releasing their results with strong foreign demand and establishing the new benchmarks for Spanish institutions (BBVA: EUR1.25bn at 5 years MS+170 and Santander: EUR1.5bn at 4 years MS+160). In the short/medium term, we expect a gradual re-opening of funding markets for the Spanish entities with the best credit ratings based on the detailed information (including a greater differentiation by issuer) of the stress tests.

The normalization of US/Euro spreads should put a break on dollar's punishment

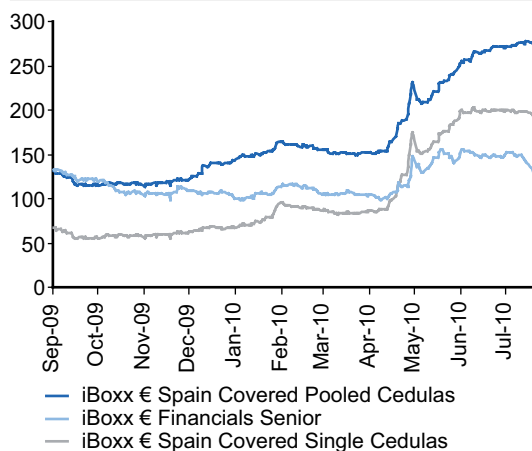
The depreciative dynamic the dollar has continued to show, even probing levels in the 1.30 dollar/euro zone, is still mainly a reflection of a change to a less optimistic outlook for the US economy, and therefore US asset valuations as well, in absolute and relative terms.

The main symptom of this adjustment is the significantly lowered outlook for rates: in line with our own revision of the first rate hike by the FED (which we do not expect before September 2011), the September expiry 3M Libor future has plummeted by around 60bps since the end of May, and is now hovering just above the 0.80% zone (a hike of just 25bps priced in to this point). The implications of this curve profile for the dollar are accentuated if we take into account that this coincides with a rise in monetary rates in other currencies such as the pound or the euro (not only for liquidity adjustment factors, but also improved expectations for rates for the region). The Sep 2011 Euribor 3M future has jumped 20bps in this period, and has even breached the upper limit of a range it had respected since late April: this is particularly relevant in view of the recent trend in the dollar/euro.

In our view, although these factors are unlikely to revert sharply in the short term, above all in view of the market's sensitivity to US data which may continue to "disappoint", they may become less significant: we do not consider aggressive decoupling between the outlooks for the Eurozone and the US to be sustainable, either in terms of the cycle (the ECB may decide to remind markets this week that the region's capacity for recovery is not risk-free) or in terms of relative rates. Therefore, with no guaranteed global recovery, an outlook of a growing dovish dollar market cannot be maintained without affecting the euro: the trend of spreads which favour the euro should start to hit limits, resulting in dollar/euro cross which is not so markedly biased towards to upper limits of ranges. Although this may not happen immediately, we still expect a return to levels closer to 1.25 dollar/euro in the medium term.

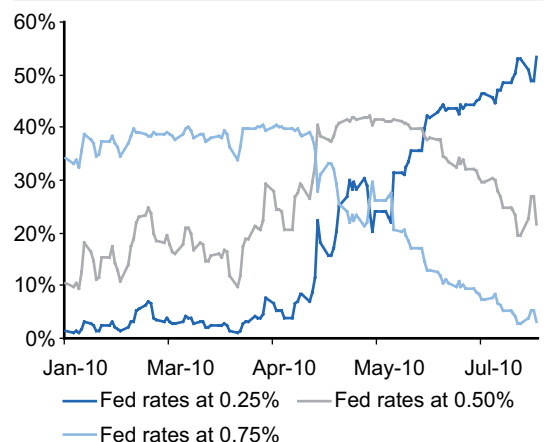
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Chart 3
Credit spreads: senior financial debt vs Spanish Covered Bonds (bps)



Source: Markit and BBVA Research

Chart 4
Implied probability of Fed Fund hikes in March 2011



Source: Bloomberg

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Positive events for the banking system: European Stress Tests and Basel agreement

The results of the EU-wide stress test exercise revealed a strong resilience of the Spanish Banking system as only 5 institutions would need extra capital under the stressed scenario (€2bn on top of the €14.6bn already granted by the FROB and DGS). These are credible results as the Spanish exercise covered almost 100% of the system (65% European average), provided more information of credit portfolios in a bank by bank basis, had a differentiated severe macroeconomic scenario especially in the Real Estate sector, and has been outstandingly rigorous in the analysis of pre-impairment incomes. Henceforth, these results will help to clarify the real situation of the Spanish banking system and remove uncertainties regarding its soundness.

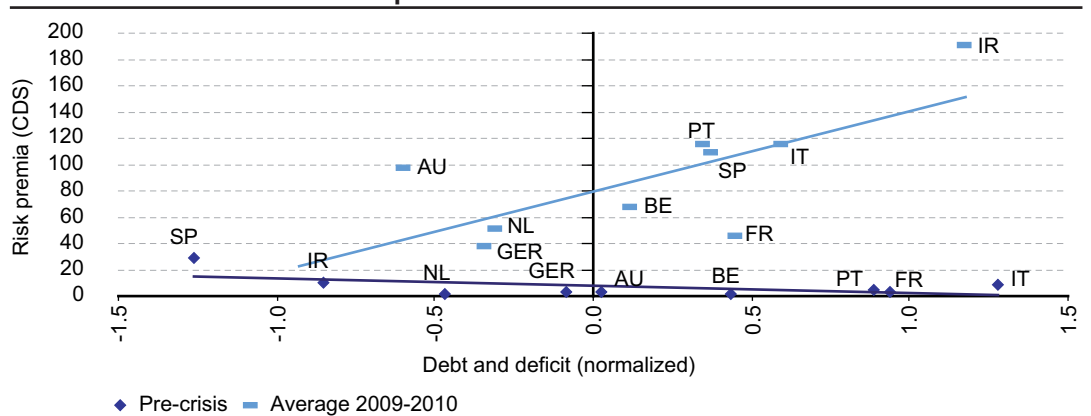
Other important news to the financial system is that the Basel Committee on Banking Supervision finally reached an agreement on the capital and liquidity reform package. It maintains most of the definitions of capital proposals but does not clarify the limits to be applied or the grandfathering period. It also includes a softening of capital deductions acknowledging that full deductions of certain categories could have potentially adverse consequences; notably, partial recognition of minority interests in a subsidiary that is a bank. The same is true for investments in other financial institutions, Mortgage Servicing Rights and Deferred Tax Assets. There are also some changes which benefit banks in the treatment and calculation of liquidity and leverage ratios. Regarding liquidity, there have been some revisions to the definition of liquid assets to extend the category of assets to consider. The Committee also recognizes that the Net Stable funding ratio should be modified to avoid a penalization of the retail banking.

Is it too soon to pull back the fiscal stimulus in core countries?

As recent data increasingly shows that the recovery will remain subdued in developed countries, there is a renewal debate about the pros and cons of early fiscal retrenchment. Undoubtedly, when financial markets start to doubt about the sustainability of a country's fiscal accounts the incentives for an early fiscal consolidation exponentially rises as the positive effect on market confidence counterweigh the negative effects on aggregate demand of an early retirement of fiscal stimulus. For EMU countries, we believe that the effect from the fiscal adjustment on growth will be lower than usually assumed and the positive impact on credibility will almost compensate the negative effect from reduced public demand. The question is if it is necessary that countries that are not (still) on markets' focus as the US which is issuing debt at record-low cost need to embark in fiscal consolidation efforts that might undermine the recovery, specially given the weaknesses on the labor market. The beneficial effects from increased confidence are not so clear in this case, and their support for global demand is important when peripheral countries are forced to restrict their own stimulus. However, fiscal variables should be closely monitored as medium-term risks should not be underestimated, as the effect of lax fiscal policy on interest rates is highly non-linear and there can be sudden increase in long-term rates with a displacement of private demand; exactly the opposite effect intended by the fiscal stimulus packages. You can find much more elaboration on these themes in the next BBVA Research Global Outlook that will be published next week.

Chart 5

EMU: fiscal variables and risk premia



Source: BBVA Research

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Calendar: Indicators

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USA: Personal Income and Spending (June, August 3rd)

Forecast: 0.1%, 0.2%	Consensus: 0.2%, 0.1%;	Previous: 0.2%, 0.4%
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Comment: Personal income is expected to rise for the eleventh consecutive month, but at a slower pace given the decline in June's non-farm payrolls. As income firms, so will personal spending, but June's decline in retail sales points to slow growth in this arena. **Market Impact:** A negative surprise in personal spending would be an indication that 2Q10 GDP could be revised down in the next release. Furthermore, an unexpected decline in personal income could point to slow spending growth in 3Q10.

USA: Non-Farm Payrolls (total, private) (July, August 6th)

Forecast: -112K, 113K	Consensus: -100K, 98K	Previous: -125K, 83K
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Comment: Total non-farm payrolls will drop for the second consecutive month in July due to the termination of temporary Census jobs. Private payrolls, on the other hand, are expected to rise, but at a slow pace. In sum, the private sector has added 593K jobs in 2010, but the pace has not been strong enough to significantly move the unemployment rate. **Market Impact:** The market will look for surprises in the private payrolls figure. A negative surprise would feed market fears about weak economic growth in 2H10.

Germany: Industrial Production Index (June, August 6th)

Forecast: 0.5 % m/m	Consensus: 1.0% m/m	Previous: 2.6 % m/m
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Comment: This week Industrial Production Index for June will be released for two of the biggest economies in the Euro Area, Germany and Italy. In Germany we expect a mild increase 0.5% m/m after April and May data recorded sharp increases. **Market Impact:** A positive surprise in Germany could imply a strong closing for Q2 and could lead to a better than expected GDP figure for the quarter, to be published in two weeks time.

Eurozone: Retail Sales (June, August 4th)

Forecast: 0.1% y/y	Consensus: -0.2% y/y	Previous: 0.2% y/y
Forecast: 0.1% m/m	Consensus: -0.1% m/m	Previous: 0.1% m/m

Comment: After the negative surprise with May data, we expect retail sales to print in June a slight positive record so as to confirm the improvement in recent consumer confidence surveys. **Market Impact:** A second negative surprise in a row would just confirm the current weak outlook for private consumption, but would not be a major surprise.

China: PMI (July, August 1st)

Forecast: 51.2	Consensus: 51.4	Previous: 52.1
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Comment: China's Purchasing Managers Index is expected to ease in July for a third consecutive month due to seasonality factors, and following the moderating trend of 2Q GDP growth (10.3% yoy, released on July 15), in line with our baseline for a soft-landing in H2 as the government's measures to rein in rapid credit growth and property price increases have been bearing fruit and as export growth gradually weakens. **Market Impact:** global investor sentiment has been very sensitive to growth indicators in China, and an unexpectedly low reading, especially if below 50, could reignite fears of a hard landing and undermine sentiment.

Mexico: Employment (July)

Forecast: 0.3% m/m	Consensus: n.a.	Previous: 0.3%
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Comment: the IMSS social security department will release its figures for job creation in the formal private sector. While in annual terms at 4.7% this will be the largest year-on-year change since February 2007, equivalent to 450 thousand new workers since the start of the year, the monthly pace of job creation will continue to show a slight deceleration against previous quarters (0.5% m/m on average during 1H10). **Market impact:** it could be limited, but considering that the risks to the US outlook, and thus Mexico's, have recently tilted somewhat to the downside, a negative surprise could potentially have an impact on markets.

Markets Data

			Close	Weekly change	Monthly change	Annual change
Interest Rates (changes in bps)	US	3-month Libor rate	0.45	-4	-8	-3
		2-yr yield	0.57	-1	-6	-54
		10-yr yield	2.93	-6	-1	-55
	EMU	3-month Euribor rate	0.90	1	11	0
		2-yr yield	0.80	5	12	-47
		10-yr yield	2.68	-3	11	-63
Exchange Rates (changes in %)	Europe	Dollar-Euro	1.303	1.4	4.8	-8.5
		Pound-Euro	0.83	-0.2	1.1	-2.4
		Swiss Franc-Euro	1.36	0.3	2.3	-10.8
	America	Argentina (peso-dollar)	3.94	0.2	0.2	2.8
		Brazil (real-dollar)	1.76	-0.3	-2.3	-5.8
		Colombia (peso-dollar)	1842	-1.4	-3.4	-9.6
		Chile (peso-dollar)	523	0.2	-3.5	-3.3
		Mexico (peso-dollar)	12.65	-0.8	-3.1	-4.3
		Peru (Nuevo sol-dollar)	2.82	0.0	-0.2	-5.4
	Asia	Japan (Yen-Dollar)	86.59	-0.8	-1.1	-8.5
		Korea (KRW-Dollar)	1181.75	-1.4	-3.7	-3.3
		Australia (AUD-Dollar)	0.905	1.2	7.8	8.8
Comm. (chg %)		Brent oil (\$/b)	76.7	-0.9	6.1	7.0
		Gold (\$/ounce)	1172.2	-1.4	-2.2	22.9
		Base metals	484.9	1.9	2.3	13.7
Stock Markets (changes in %)	Euro	Ibex 35	10552	1.6	15.0	-2.8
		EuroStoxx 50	2748	1.1	9.1	4.2
		USA (S&P 500)	1100	-0.2	7.1	11.4
	America	Argentina (Merval)	2398	1.0	8.5	39.4
		Brazil (Bovespa)	67135	1.2	9.6	22.6
		Colombia (IGBC)	13201	-0.5	6.6	27.8
		Chile (IGPA)	20263	1.2	8.4	32.5
		Mexico (CPI)	32366	-1.3	3.7	19.7
		Peru (General Lima)	14191	0.3	2.6	0.7
		Venezuela (IBC)	64273	-0.2	-1.4	40.6
	Asia	Nikkei225	9537	1.1	3.8	-7.9
HSI		21030	1.0	4.5	2.2	
Credit (changes in bps)	Ind.	Itraxx Main	105	-7	-26	17
		Itraxx Xover	478	-28	-107	-135
	Sovereign risk	CDS Germany	38	-3	-6	13
		CDS Portugal	216	-52	-90	170
		CDS Spain	179	-23	-84	120
		CDS USA	34	-2	-3	---
		CDS Emerging	214	-17	-61	-114
		CDS Argentina	792	-54	-209	-910
		CDS Brazil	117	-3	-25	-17
		CDS Colombia	124	-4	-29	-48
		CDS Chile	83	-7	-22	-8
		CDS Mexico	116	-4	-23	-46
		CDS Peru	109	-4	-29	-38

Sources: Bloomberg, Datastream and JP Morgan

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