

Global

# Weekly Watch

Madrid, 23 December 2010

## Economic Analysis

*Financial Scenarios*

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## Uncertainty continues

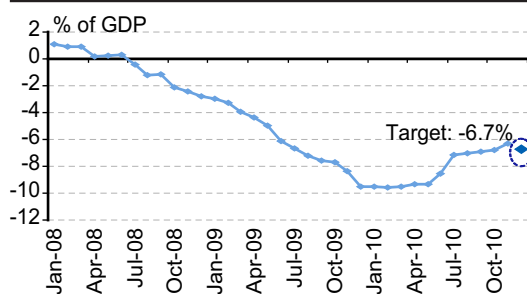
Changes in Germany's approach to the resolution mechanism, toward greater European integration makes it more likely that a coordinated solution will be achieved in the next European Council Meeting. In our view, this makes the worst case scenario for Europe less likely and prevents a significant additional increase in the European risk premium. The EU intends to launch its first bond issue at the beginning of January, which will be a good reference for the market to track sovereign risk. Short term markets, however, remain sensitive to peripherals' news flows. Regarding this, Moody's has put under review for a potential downgrade not only the ratings of Spain and Portugal but also the ratings of their banks. To this we must add the 5 notch downgrade of Ireland to Baa1. In the case of Portugal, sovereign debt ratings are 3 notches above those of Ireland. Moreover, under the new Credit institutions Act, which avoids seeking shareholder approval, the Irish State will pump a further EUR3.7bn into Allied Irish via the National Pension Reserve Fund.

## Improved confidence in Spanish Sovereign debt

Spanish real budget figures are in line to achieve the 2010 deficit target, which the government was advising, but the market was sceptical. Spanish Regions' average deficit rose to 1.24% of GDP in the first nine months of the year, in line with expectations, which put all Spanish Regions on track to meet the full-year fiscal goal of 2.4% of GDP. Also, Spain's central-government budget deficit narrowed to 3.68% GDP (-45.8%) in the 11 months through November vs. 6.79% in the same period a year earlier. Additionally Spanish parliament approved 2011 budget. In contrast, budget figures from Portugal have shown less fiscal consolidation margin up to today. Also, the Greek parliament approved an austerity budget early on Thursday but without the opposition party's support.

Chart 1

### Spanish Central Government Budget (12m accumulated)



Source: Ministry of Economy and Finance and BBVA Research

Chart 2

### Spain: 2yr Bond Yield Spread against Italy



Source: Bloomberg and BBVA Research

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## Highlights

### Commodities favored by investors

Inflows to Commodities will continue to be a positive factor during all of 2011.

### German spillovers expected to sustain the EZ recovery

The balance of trade will be the channel for transmitting growth.

### ECB's liquidity policies

After the boundless amount demanded by banks in December's 3-M and fine-tuning auctions, liquidity in the Euro area is expected to remain at high levels.

Markets Analysis

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**Continued scepticism in Europe, and more confidence in emerging markets**

Forex markets have shown two clearly different profiles, which are significant above all in terms of their relationship with local and global risk premiums. On one hand, we must highlight the limited positive impact that the latest announcements made in the Eurozone seem to have had, particularly regarding future rescue mechanisms. Not only is the euro unable to recover versus the dollar and continues to threaten 1.30 EURUSD, this lack of support is being passed on to the most financially linked currencies: the pound has continued to correct (now at 1.53 vs. USD), partially reflecting this link, partially pricing in some weakness in UK data (disappointing GDP and budget cuts). In this context, the strength shown by the CHF is significant (at historical Eff. Exc. Rate highs), which relates to its currently particularly strong position as a safe-haven.

However, offsetting this somewhat, the market is continuing to limit the risk of systemic contagion from this situation to emerging markets: the dollar is not strengthening aggressively against the region's currencies and has even ceded slightly vs. LatAm currencies. The stability of the fundamentals in these regions is the main factor that may be preventing a greater knock-on effect: a continued profile supported by emerging markets may help to reduce, but not eliminate, the underlying strength we still perceive in the USD vs. currencies such as the euro and the pound.

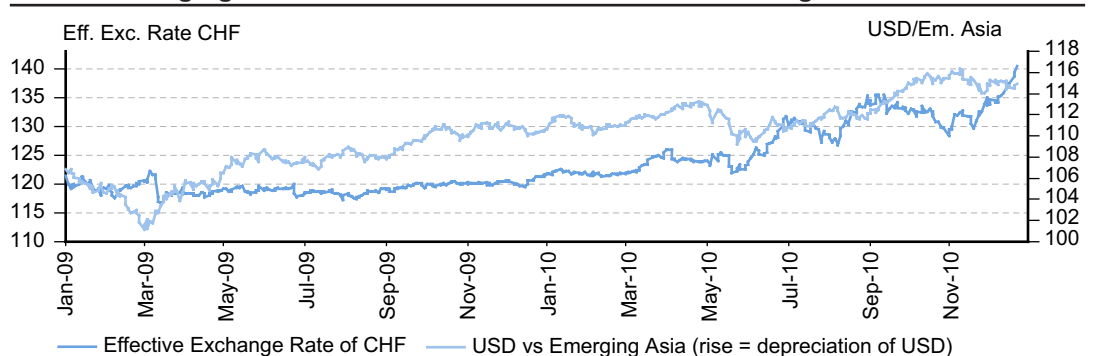
**There is still underlying upside potential, but we remain cautious**

The S&P 500 is more removed from the trend of European sovereign risk and has already reached our year-end target (1,250 points). We continue to see more upside potential in the EuroStoxx 50, above all depending on how banks perform. In this sense, the fact that Germany is slightly softening its position vis-à-vis sovereign risk management in Europe, together with the possibility that China might buy European countries' bonds has helped to boost financial stocks (European banks are again trading at an attractive multiple: 0.87x P/BV 10e).

What is more, as shown in the chart, implied volatility (VIX at 16.3% and V2X at 18.2%) is at lows for the year. These figures represent a clear message and position in terms of European sovereign risk: there will be no systemic risk derived from a major impact on the banking sector, apart from the underperformance we are seeing in banks. The upside potential for equities may therefore materialize in the coming months, but we remain cautious.

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Chart 3  
**USD vs Emerging Asian Currencies and CHF Effective Exchange Rate**



Source: Bloomberg

Economic Analysis

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**Commodities favored by investors**

During the second part of 2010 commodities have appreciated excessively, most by more than 25%. Some assets, such as grains have had some problems with supply but the main reason for this performance was investors' increased exposure to commodities. In fact, non-commercial positions have reached their highest historical level. Looking ahead to the next year, we could see some corrections in the short term, but consolidation levels are increasing as Emerging Economies, led by China, boost demand. These corrections are explained by the huge inflow of funds to commodities recently, which soon or later could trigger profit-taking, accompanied by a strengthening movement in the dollar. Although the pace of inflows should moderate in coming months, it is going to remain a positive factor during the whole year. More specifically, for crude oil we are expecting a price consolidation above 85 dollars/barrel.

**German spillovers expected to sustain the EZ recovery**

Recent data on the German economy show more evidence that the positive economic momentum remains, with an incipient improvement in domestic demand that should complement exports. But leading indicators also point to some slowing of activity in coming months, somehow expected after the unusually strong momentum of recent months. Still, the German economy will be on a clear growth path next year, confirming the divergence between growth in Germany and most Eurozone countries observed in recent quarters. Against this background, the key issue now is to what extent the German economy could lead the recovery in the Eurozone as a whole. In this sense, most exports from member states remain within the euro area, and the share of exports to Germany is large (between 10% and 15% in France, Italy, Spain, Portugal, and over 20% in Austria and the Netherlands). In addition, those exports are high correlated with German GDP growth (0.6 in Italy and around 0.5 in most member states), suggesting that Germany will end up driving the economies of other member states. German exports to Asia and elsewhere require intermediate goods from many other Eurozone countries. The less positive reading is that this correlation is lower for some peripheral countries that are hardest hit by the sovereign crisis, such as Portugal (0.1) and Ireland (0.1).

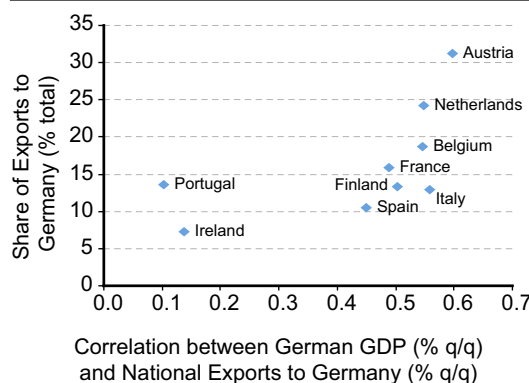
**ECB's liquidity policies**

This week Eurozone banks repaid the largest amount to the ECB since September (when EUR 225bn of one-year and six-month loans matured), totaling EUR 201bn, which was injected in 12M and 3M (EUR97 bn and EUR104bn respectively). In December's 3M LTRO the funds allotted were €149.5 bn, with a total number of bidding institutions of 270. This high participation shows that sovereign debt concerns maintain a strong hoarding motive in banks' liquidity policies. In the 13-day fine-tuning operation the demand for liquidity was EUR20.6bn and bids came from only 32 institutions. As we expected, the results of the 3M LTRO and 13 day fine-tuning operation showed that banks rolled over 85% of the EUR 201bn (higher than the roll-over rate of the other two big maturities which were around 55%), mainly due to the fact that the main sources of funding remain closed in Europe. These uncertainties point out that liquidity normalization is occurring at a slow pace. Moreover, the provision of liquidity in LTROs and MROs has remained at high levels in the current quarter, specifically regarding weekly MROs which have rallied since September's maturing, and have remained constant during this quarter at approximately EUR180bn. Furthermore, the concentration of the ECB liquidity provision in some of the most vulnerable countries remains at high levels, such as in the case of the Greek, Irish and Portuguese banking systems in which ECB liquidity provision is increasing.

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Chart 4

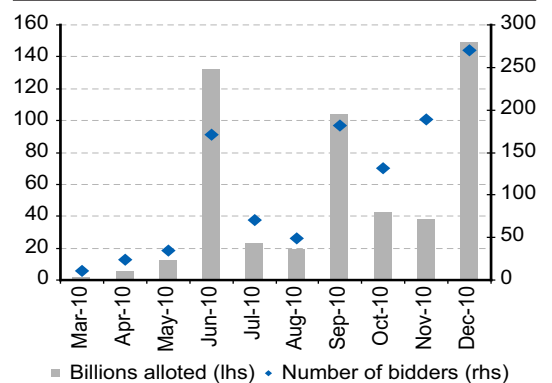
**Exports to Germany**



Source: Datastream and BBVA Research

Chart 5

**ECB: 3M LTROs**



Source: ECB and BBVA Research

## Economic Analysis

## Calendar: Indicators

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## Eurozone: M3 (November, December 29th)

<b>Forecast:</b> 1.4% y/y	<b>Consensus:</b> 1.6% y/y	<b>Previous:</b> 1.0% y/y
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**Comment:** Eurozone lending data for November are expected to show further evidence that the positive sentiment on conditions observed in recent months continues, although there is still a very cautious tone rather than a clear recovery. In particular, M3 is expected to have remained virtually flat over the previous month, resulting in a higher year-on-year rate at around 1.4% y/y. Across its counterparts, loans to households are projected to have continued growing at similar rates to those recorded over last year (around 0.2% m/m), while those to non-financial corporations are likely to have increased slightly (around 0.2% m/m), after declining slightly in the previous months and hovering around 0% m/m since the beginning of the year. Although the declining pace of the latter seems to be interrupted, there is no a clear turnaround yet. **Market Impact:** A sharp decline in loans to private sector could be read by markets as an adversely effect of renewed financial strains on credit facilities.

## Germany: Flash HICP inflation (December, December 29th)

<b>Forecast:</b> 1.8% y/y	<b>Consensus:</b> 1.6 % y/y	<b>Previous:</b> 1.6% y/y
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**Comment:** After a significant, and in part unexpected, acceleration of headline inflation in the previous month, we expect it to accelerate again in December, although at a more moderate pace. We see higher prices of both energy and products as the drivers of this monthly increase, as in November. The detailed breakdown will not be released with the flash estimation, but we think that core inflation could have also increased slightly, driven by higher prices of non-energy industrial goods, while service inflation should have remained stable at low levels. Overall, we see headline inflation to be close, but below the ECB target next year. **Market Impact:** A sharper acceleration in inflation could significantly affect markets, as they may fear a more hawkish mode by the ECB.

## US: Consumer Confidence (December, December 25th)

<b>Forecast:</b> 57.0	<b>Consensus:</b> 56.1	<b>Previous:</b> 54.1
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**Comment:** Consumer confidence is expected to increase for the third month in a row in December, yet it will remain significantly low compared to its historical average of 94.7. The current trend in consumer confidence indicates that although consumers' economic outlook is weak it shows signs of improvement in the last couple of months. With the latest fiscal stimulus bill signed by the President Obama last week is expected to boost business confidence and improve consumers' expectations on labor market conditions. Therefore, we expect increase in consumer confidence in the next couple of months but at a low pace. **Market impact:** A drop in consumers' confidence in December might point to a slowdown in personal spending in December as well.

## US: Chicago PMI (December, December 27th)

<b>Forecast:</b> 61.5	<b>Consensus:</b> 62.5	<b>Previous:</b> 62.5
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**Comment:** In November, Chicago Business barometer, also known as Chicago PMI increased to its highest level since April. The index has increased for the last fourteenth months. The report indicates that production and new orders reached its highest level since February 2005 and 2007, respectively. While employment index marked a sixth month of growth, index for inventories dropped below 50 indicating contraction in employment in the region. We expect Chicago PMI to slide slightly in December, yet remain above 50 indicating expansion in economic activity in the region. **Market impact:** Increase in Chicago PMI would point to an increase in ISM manufacturing in December.

## Korea: CPI Inflation for December (December 31st)

<b>Forecast:</b> 3.3% y/y	<b>Consensus:</b> 3.2% y/y	<b>Previous:</b> 3.3% y/y
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**Comment:** Korea's inflation has recently moderated, back to within the Bank of Korea's (BoK) inflation target range of 2-4% following a spike to 4.1% y/y in October on rising food prices. Nevertheless, upward pressures are expected to remain into 2011 from rising commodity prices and strong domestic demand, and consequently the BoK has signaled further rate hikes. **Market Impact:** A higher-than-expected outturn would intensify expectations of further rate hikes in the coming months.

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## Markets Data

			Close	Weekly change	Monthly change	Annual change
<b>Interest Rates</b> (changes in bps)	<b>US</b>	3-month Libor rate	0.30	0	2	5
		2-yr yield	0.66	2	12	-31
		10-yr yield	3.39	-4	48	-42
	<b>EMU</b>	3-month Euribor rate	1.02	-1	-2	31
		2-yr yield	0.94	-14	-3	-25
		10-yr yield	2.98	-9	27	-35
<b>Exchange Rates</b> (changes in %)	<b>Europe</b>	Dollar-Euro	1.307	-1.3	-2.3	-9.0
		Pound-Euro	0.85	0.1	0.1	-5.8
		Swiss Franc-Euro	1.26	-1.7	-5.4	-15.8
	<b>America</b>	Argentina (peso-dollar)	3.98	0.1	0.1	4.7
		Brazil (real-dollar)	1.70	-0.3	-1.4	-3.7
		Colombia (peso-dollar)	1931	0.8	2.1	-5.5
		Chile (peso-dollar)	469	-1.1	-2.7	-7.3
		Mexico (peso-dollar)	12.32	-0.8	-0.2	-4.3
		Peru (Nuevo sol-dollar)	2.80	-0.5	-0.3	-2.8
	<b>Asia</b>	Japan (Yen-Dollar)	83.11	-1.3	-0.3	-9.3
		Korea (KRW-Dollar)	1154.65	-0.3	0.5	-2.4
		Australia (AUD-Dollar)	1.003	1.5	1.9	13.5
<b>Comm.</b> (chg %)		Brent oil (\$/b)	93.8	2.2	9.2	22.9
		Gold (\$/ounce)	1375.6	0.4	0.2	24.4
		Base metals	580.4	1.1	5.4	20.0
<b>Stock Markets</b> (changes in %)	<b>Euro</b>	Ibex 35	10127	1.2	3.9	-15.4
		EuroStoxx 50	2865	0.7	3.9	-3.1
	<b>America</b>	USA (S&P 500)	1257	1.1	4.9	11.6
		Argentina (Merval)	3487	4.5	6.2	55.0
		Brazil (Bovespa)	68407	1.6	-1.8	1.2
		Colombia (IGBC)	15587	1.3	3.5	34.2
		Chile (IGPA)	22853	-1.7	-1.1	39.2
		Mexico (CPI)	38157	0.9	2.9	17.2
		Peru (General Lima)	22684	2.9	11.0	61.1
	<b>Asia</b>	Venezuela (IBC)	65174	0.4	-1.5	18.7
		Nikkei225	10346	0.3	3.2	-1.8
	HSI	22903	1.0	-0.5	6.4	
<b>Credit</b> (changes in bps)	<b>Ind.</b>	Itraxx Main	105	0	-3	30
		Itraxx Xover	437	-9	-47	-15
	<b>Sovereign risk</b>	CDS Germany	57	4	16	31
		CDS Portugal	489	37	13	399
		CDS Spain	348	24	51	238
		CDS USA	42	3	1	---
		CDS Emerging	207	-8	-17	-54
		CDS Argentina	610	-40	-49	-297
		CDS Brazil	114	-1	2	-8
		CDS Colombia	115	-2	1	-28
		CDS Chile	77	2	-6	1
		CDS Mexico	116	-1	0	-17
		CDS Peru	118	0	-1	-6

Source: Bloomberg and Datastream



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