FINANCIAL MARKETS

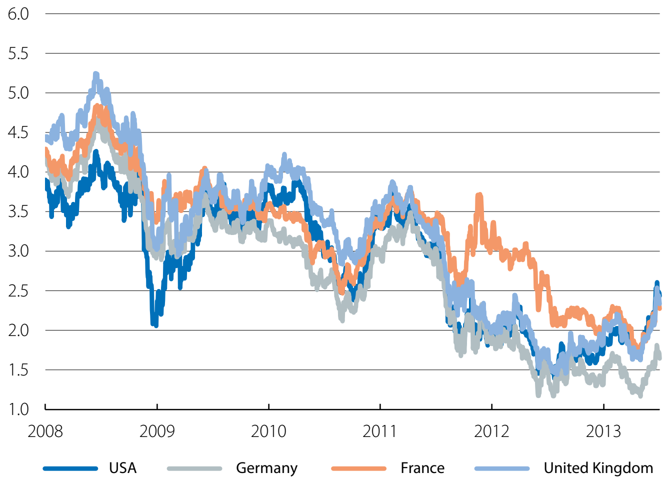
The performance of international financial markets in June has been unstable. The two large sources of concern appearing in May (the Federal Reserve and China) have worsened over the last few weeks. Bond yields have rallied strongly in the vast majority of countries, credit risk premia have risen, stock markets have seen losses and the currencies of emerging countries have continued to depreciate, all this within an environment of greater volatility and contained trading volumes. It is noteworthy and revealing that the climate in the euro area markets, particularly in Spain, has been relatively constructive in spite of this deterioration in its surroundings.

The Federal Reserve (Fed) has presented its roadmap. After the messages given out by several members of the Fed in May regarding the appropriateness of reconsidering stimuli measures, all eyes were on the meeting of the Monetary Policy Committee held on 19 June. As explained in more detail in the Focus «The Federal Reserve's controversial "exit strategy"», Ben Bernanke announced a plan to withdraw stimuli regarding both quantitative easing and the handling of official interest rates. The reflex action of investors consisted of significant sales in almost all markets throughout the globe, with some nervous moments. Somehow, investors did not completely rule out the possibility of the Fed establishing specific conditions and dates to withdraw the overabundance of liquidity and its calming effects. And even less so the fact that this might start soon: before the year ends.

The process designed to normalize monetary policy will be gradual and in proportion to the improvement in economic fundamentals. Bernanke himself made a huge effort to stress this point but to no avail. Given the market instability, with the consequent risk of implementing harmful mechanisms that amplify and transmit such turbulence, several Fed members entered the fray. Although expressing somewhat disparate views, they all agreed that the official plan did not mean slamming on the brakes but rather easing the foot off the accelerator of stimuli. Moreover, some highlighted the fact that, if economic developments turned out to be disappointing, they would be fully prepared to increase expansionary measures. Towards the end of the month, these messages finally managed to calm fears to some extent, resulting in a partial recovery of the previous deterioration both in bonds and equity.

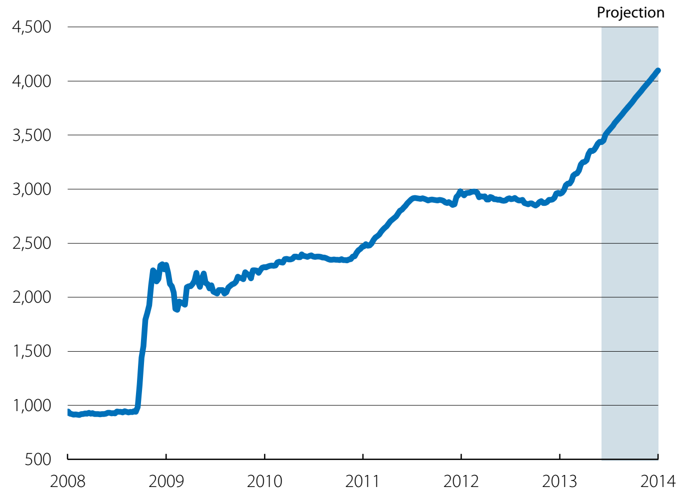
The holiday period that is now starting is not the best time for volatility to diminish but, taken from a medium and long-term viewpoint, the plan outlined by the Fed appears to have more advantages than drawbacks in terms of financial markets. Striking a balance between transparency and specifics on the one hand and flexibility and a gradual approach on the other arouses uncertainty, at the same time as outlining a scenario of lax monetary conditions for a long

Yields on 10-year sovereign debt
(%)



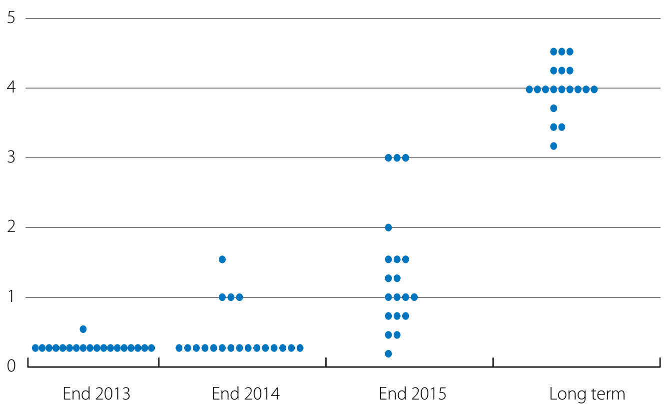
Source: *Bloomberg.*

USA: assets on the Fed's balance sheet
(Billion dollars)



Source: *Bloomberg.*

Fed: appropriate level for official interest rate according to 19 Committee participants on 19 June
(%)



Source: *US Federal Reserve.*

time. As the economic expansion consolidates, risky financial assets (such as the stock market) will benefit and pick up again. For their part, the yields on US government bonds (and consequently the rest of the countries) should correct part of their sharp rise seen over the last two months, followed by a much calmer upward path.

Although gradual, the change in the monetary regime has powerful implications for financial markets. The economic and monetary normalization of the world's leading economy, together with the reasonably positive trend we expect for the rest of the regions, suggests that the underlying economic fundamentals of the different countries and sectors will become increasingly important, with a particularly significant role for the figures on the US labour market. Little by little, the alternating risk-on/risk-off dynamic, so typical over the last few years, will disappear.

The emerging countries are still a cause for concern. The storm caused by the Fed has hit the emerging bond and equity markets particularly hard, suffering from capital outflows and currency depreciation. The underlying weak economic pulse of these countries has merely encouraged such behaviour. China is the most outstanding case but there are also doubts regarding developments in Brazil, India and others.

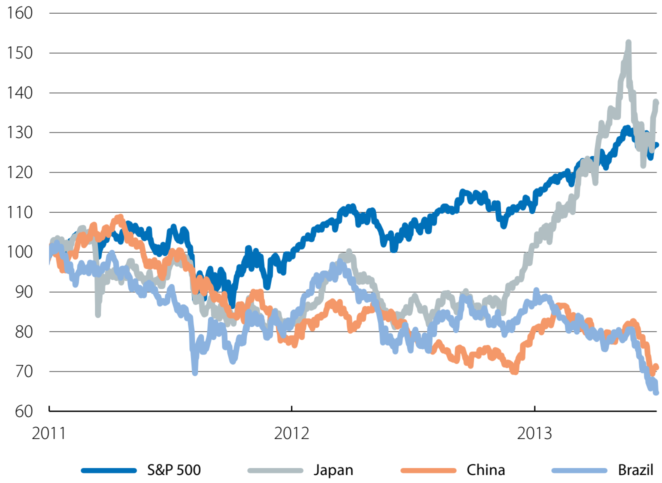
China has provided a shock in the form of interbank market tension. The sudden rise in monetary interest rates reminded international investors of episodes in the USA in 2008 and in the euro area in 2011, in both cases a prelude to far-reaching problems. China's stock market reacted with big losses that contributed to the overall bad tone. As explained in the Focus «China: interbank tensions», the origin of these tensions in the Chinese interbank market lies in temporary technical factors for which the central bank has adopted a «tough» stance, delaying its intervention so as not to exacerbate the risk of bubbles forming in the future. Whatever happens, this episode highlights the problems facing China to sustain its rate of expansion while changing the model and attempting to ensure financial stability.

Social unrest is adding a new dimension to the problems of the emerging countries and Brazil, Turkey and Egypt are the main exponents in this respect. The situations appear to be under control for the time being but we should not underestimate the geopolitical risk involved. If this came about, it might be systemic in scope and accentuate threats to financial stability and economic performance. In short, the emerging countries are currently a weak link that is sullying the global panorama. In any case, the most likely course is still one of progressive improvement due to the reasonably solid financial position (indebtedness) of most of these countries, the ample room to manoeuvre for their monetary and fiscal policies and also the recently improved tone of the developed economies.

Japan's financial markets are stabilizing. Following their own, differentiated dynamic, the Japanese stock market, bonds and currency have calmed down their extremely

Trends in the main international stock markets

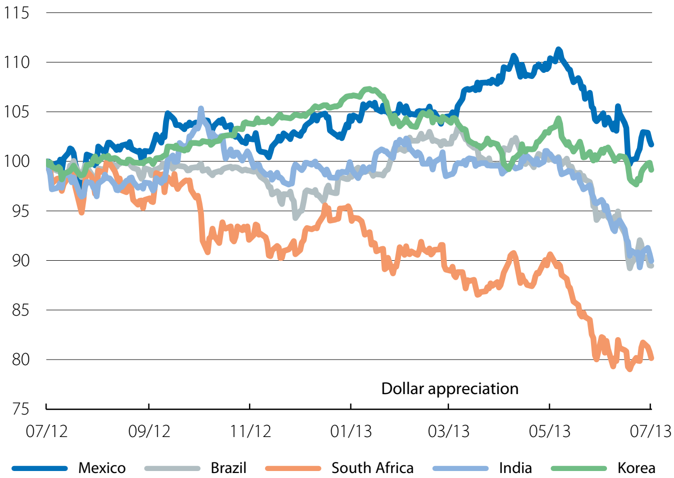
(January 2011 = 100)



Source: *Bloomberg.*

Trend in different currencies against the dollar

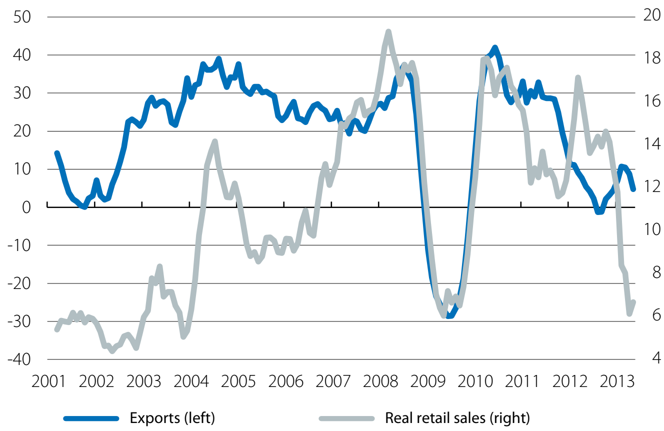
(July 2012 = 100)



Source: *Bloomberg.*

Emerging economies: exports and retail sales (*)

(Brazil, Russia, India and China weighted by GDP PPP; 3-month moving average, year-on-year change)



Source: *Bloomberg.*

volatile behaviour of May. This supports the interpretation that it was a correction phase after the sharp movements implemented in the wake of the policy known as Abenomics, and not a boomerang effect of this policy. In fact, the measures of quantitative easing implemented by the Bank of Japan over the coming months will help significantly towards the overall situation of abundant liquidity we expect, even if the Fed stops its bond purchases.

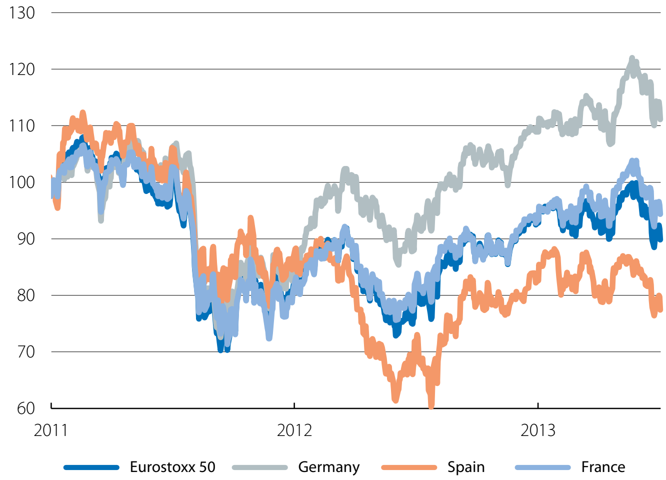
The euro area remains in second place but it's not immune. The region's financial assets have not escaped the turbulence generated by the Fed and the emerging countries and punishment has even been particularly harsh in some quarters. This is the case of the stock markets given that the firms on the region's selective indices are greatly exposed to the emerging markets. However, internal factors related to the long and complex debt, institutional and economic crisis have had an influence that ranges from neutral to positive. Tensions on periphery risk premia have therefore been moderate and, in the last part of the month, had already dissipated quite quickly. Spain's spread with Germany at 10 years rose from 290 b.p. to 320 but then fell back again to its initial level. The trend in the euro-dollar exchange rate has also been up and down, ranging between 1.30 and 1.34, within the range of fluctuation of the last few months and where it is likely to remain.

The European summits have neither surprised nor disappointed. Investors have interpreted the agreements reached by Ecofin and the European Council with the perspective of a «bottle half-full». On the one hand, in the area of structuring banking union it has been confirmed that the progress being made is slow but sure. The perception of bank risk and its harmful connection with sovereign risk has not undergone any significant change, as shown by the relatively stable performance by banks' CDSs. On the other hand, the programme to combat youth unemployment and facilitate SME financing are modest steps but in the right direction. With regard to the latter, the ECB has yet to provide details on the terms of its involvement, which does not look like being very aggressive. However, Mario Draghi and other leading members of the ECB have made statements regarding the orientation of monetary policy as a whole after the Fed's plans were announced. The message is clear: the ECB's «exit strategy» has yet to be glimpsed on the horizon, particularly in the area of official interest rates. With this it is attempting to put a stop to the incipient rise taking place in monetary interest rates (the 12-month Euribor has once again risen to above 0.50%).

The respite seen in the last few months in the euro area crisis cannot be considered as definitive. Risks are still high, in particular those resulting from the fragile pulse of economic activity. The recently perceived improvement is promising but it must continue in order to allay the threats hovering over key elements, such as the banking sector and periphery countries with weak governments.

Euro area stock markets: trend by country

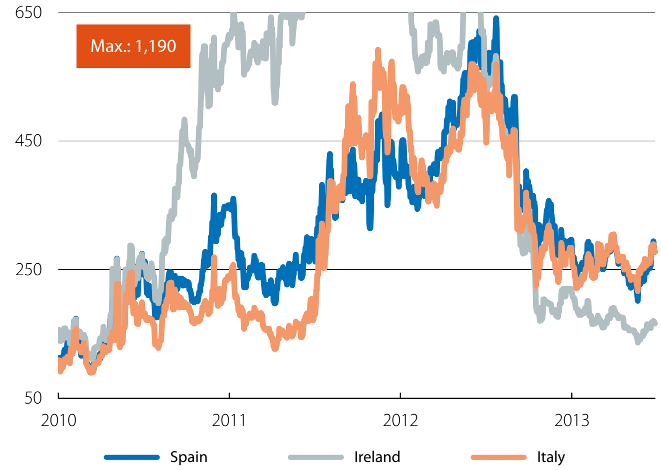
(January 2011 = 100)



Source: *Bloomberg.*

Sovereign debt risk premia

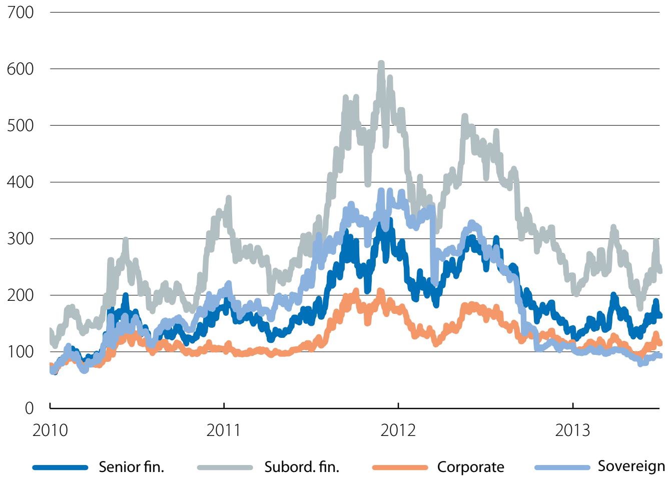
(CDS; basis points)



Source: *Bloomberg.*

CDS premia in Europe by type of issuer

(Basis points)



Source: *Bloomberg.*