FINANCIAL OUTLOOK · **Upswing in risk aversion given the uncertain future**

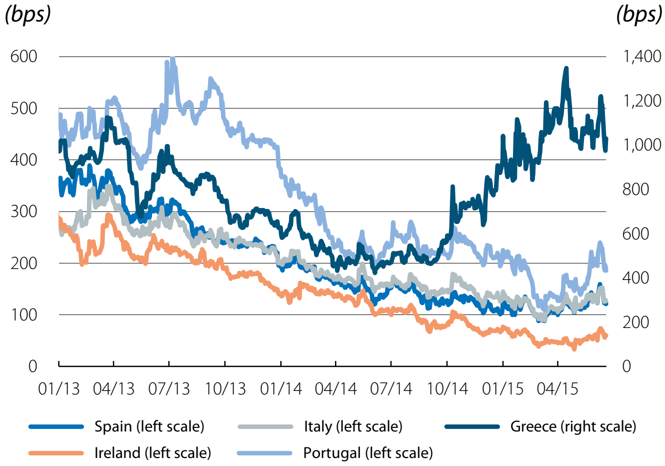
The reappearance of the spectre of a potential Grexit in the last few days of June is leaving its mark on the markets. In any case, the derailment in negotiations between Greece and its creditors has had a limited impact on European stock markets and peripheral bond risk premia. Unfortunately, in the short term investor sentiment is dominated by the high uncertainty resulting from Greece's political and economic situation. Although it is now more likely that the outcome of the Greek issue will be adverse, our main scenario still assumes that the country will remain in the euro area. On the other hand, as the euro area's mechanisms designed to contain potential increases in financial instability are now fully operational, this limits the scope and possible contagion to the rest of the region.

The news coming from Greece will dominate the international financial scene this summer, already a less than favourable time of year. Consequently the volatile tone of the international financial environment, far from abating, will continue throughout the summer months. In addition to the ups and downs caused by the Greek saga, the actions taken by the Federal Reserve (Fed) regarding interest rates is another important factor in the trend of international markets. We do not expect any huge changes in this area: the Fed will kepp its message of a gradual, conditional normalisation of interest rates based on the incoming economic activity data and the expected path of inflation.

The resilience of periphery sovereign debt has become more important after the sell-off of German public debt in spring and worsening tension in Greece and the imposition of capital controls in the country. The initial reaction by investors intensified «flight to quality flows» in search of a safe haven (mainly German public debt) and also the sale of periphery debt. However, the resulting upswing in periphery risk premia has been subdued (in the order of 30 bps in Spain and Italy and 40 bps in Portugal). Improved macroeconomic and financial conditions, the regularisation of the banking sector and various mechanisms to contain risk have limited the extent of possible contagion to the rest of the periphery countries. Proof of this is that mechanisms to transmit and amplify financial tensions have not been started up, unlike what happened during the euro area crisis in 2011 and 2012.

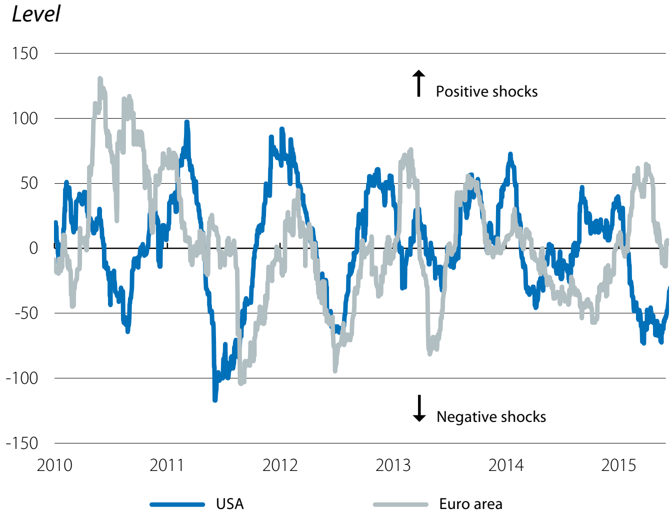
The ECB's actions are key on several fronts. On the one hand, the monetary authority's Governing Council decided to continue providing Greek banks with emergency liquidity assistance (ELA). Although it can stop this liquidity facility

*Euro area: 10-year public debt risk premia **



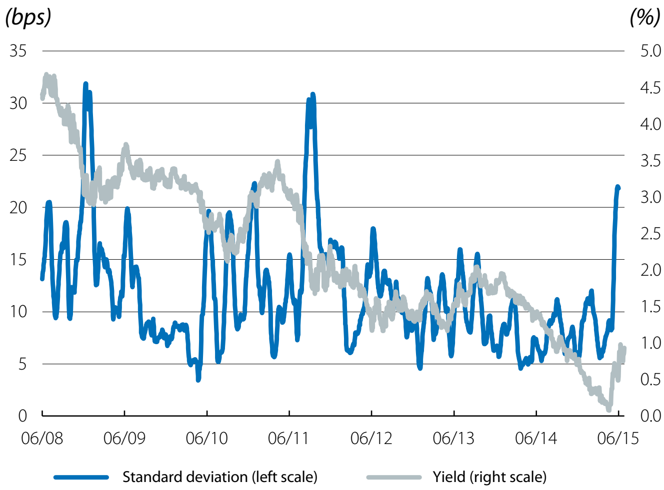
Note: ** Spread compared with German 10-year bond.*
Source: *"la Caixa" Research, based on data from Thomson Reuters Datastream.*

Index of economic shocks



Source: *"la Caixa" Research, based on data from Bloomberg.*

Germany: yield and volatility of 10-year public debt



Source: *"la Caixa" Research, based on Bloomberg data.*

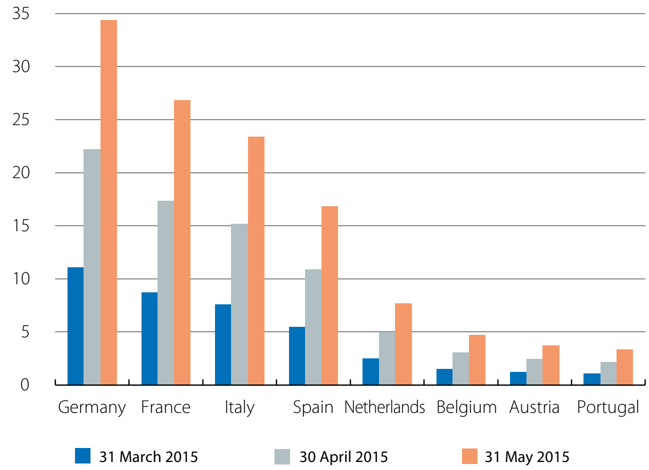
when bank solvency is called into question, the European Central Bank (ECB) is unlikely to adopt such a far-reaching decision: stopping ELA would precipitate a *de facto* Grexit from economic and monetary union. On the other hand the institution has considerable ammunition to tackle a potentially turbulent episode in sovereign debt markets. In particular the ECB can opt to temporarily shift the centre of gravity of its bond purchases from sovereign QE towards periphery debt. If necessary, it can also make full use of OMTs (outright monetary transactions), announced in the summer of 2012 and whose legality has been ratified recently by the European Court of Justice.

The path of the Fed's monetary normalisation at the heart of debate. The Fed's June meeting provided further clues as to its expected strategy to raise interest rates with a view to the next few years. The Chair of the monetary authority, Janet Yellen, confirmed the intention of the Federal Open Market Committee to start raising the official interest rate in the last few months of 2015, once the improvement in the labour market has been confirmed and inflation moves closer to 2%. The Fed members still expect moderate expansion for the US economy although the temporary standstill in GDP in 2015 Q1 has forced them to reduce their growth forecast for 2015 (from 2.5% to 1.9% annually). Although the debate regarding which month will see the first official interest rate hike (September or December) is still a source of discrepancy among the Committee's members, attention on the messages is starting to revolve around the expected rate of rises in the medium and long term. Regarding this last point, Yellen stressed that monetary policy will continue to be accommodative after the first hike in the official interest rate. This, together with the reduction in the path of the official interest rate forecast by Fed members, confirms our scenario of a very gradual monetary normalisation.

Treasury yields continue the upward trend started in April. The imminence of the first official interest rate hike by the Fed has supported the increase in yields on US sovereign debt. Upward pressures have been particularly significant in the longest tranche of the Treasury curve. Specifically, in June the yield on 10-year bonds rose by 20 bps compared with the 2 bps increase seen in 2-year Treasury bonds. This advance has also been supported by better inflation expectations over the medium to long term. In the coming months we expect both factors to continue boosting the sustained rise in interest rates. However, it is very likely that the dependence of the Fed's monetary policy on the trend in economic data and European sovereign debt market tensions will keep public debt volatility at a relatively high level during the third quarter of the year.

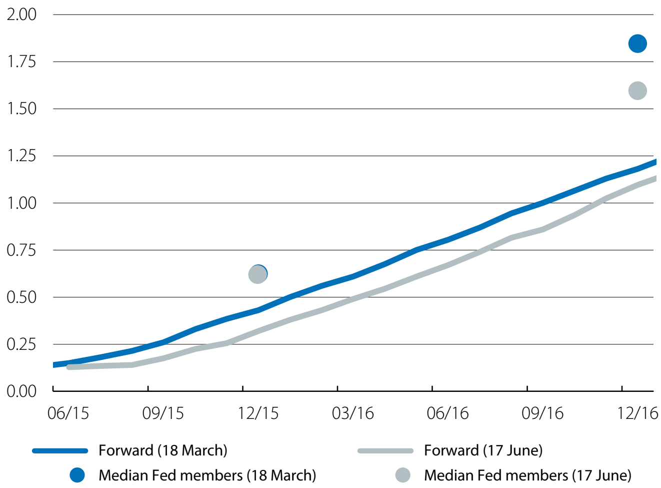
Investor appetite towards emerging countries shrinks. The upswing in risk aversion in financial markets has slowed down the flow of portfolio investments towards the

ECB: cumulative purchases of public debt by country
(Billion euros)



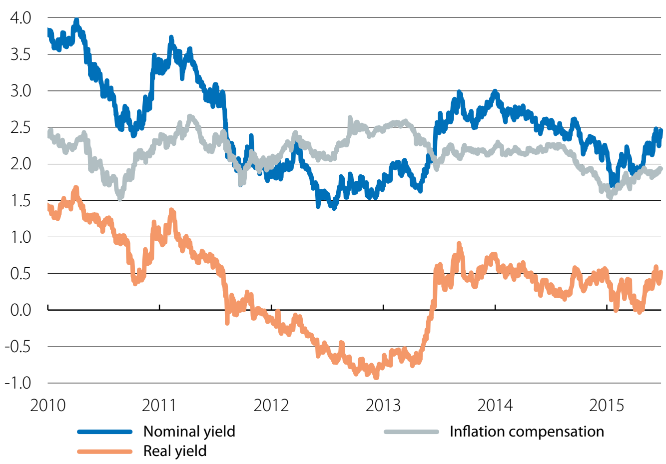
Source: *"la Caixa" Research, based on Bloomberg data.*

USA: Fed official interest rate projections
(%)



Source: *"la Caixa" Research, based on Bloomberg data.*

USA: breakdown of the yield on 10-year bonds
(%)



Source: *"la Caixa" Research, based on Bloomberg data.*

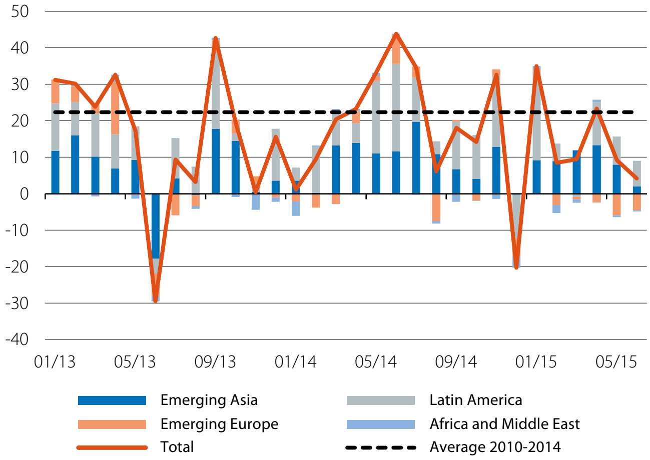
emerging bloc in the last few weeks. Although the impact of this slowdown on the spreads of the emerging bonds and currencies has been relatively moderate, it has not eliminated doubts regarding the consequences of the start of interest rate hikes in the US. On the one hand, Brazil and Turkey are looking like the most vulnerable countries to the imminent turnaround in the Fed's monetary policy. On the other hand, the slowdown of the Chinese economy is still a source of risk, although limited thanks to the room for manoeuvre enjoyed by its monetary policy. In this respect, the strong fluctuations in China's stock market have resulted in the country's central bank adopting further monetary stimuli. Specifically, the institution cut the official lending rate by 25 bps for the fourth time since November, as well as the official deposit rate, down to 4.85% and 2.0% respectively. At the same time, the central bank also reduced the ratio for banks' mandatory reserves by 50 bps, down to 16.0%.

International stock markets become immersed in a period of uncertainty. The doubtful tone of the last few weeks has continued in the US stock market, awaiting possible clues from the Fed regarding the future trend in interest rates and the publication of macroeconomic data. Across the Atlantic, a downward slide has consolidated in European stock markets given the lack of resolution of the Greek crisis, which looks like affecting the trend in the Old Continent's stock markets over the coming weeks. Under such circumstances, the correction in stock markets is more likely to continue than a phase with the opposite trend. Similarly, current conditions will maintain the dynamic of the last few months throughout the summer, characterised by the US stock market performing relatively better than the European market. However, the focus of investors will gradually shift towards fundamental indicators (macroeconomic environment and corporate earnings) as the issues underlying the Greek situation become clearer. On the other hand, the corrections in China's stock market are likely to continue during the summer due to the still high levels of investor leverage.

Trends in the euro and oil are still unclear, awaiting Greece and the Fed. With questions hovering over the outcome of the Greek crisis and interest rate rises in the US, the euro is still somewhat erratic, fluctuating within the range of 1.14-1.11 dollars. Although debate regarding euro-dollar parity has eased in the last few weeks, we believe the euro is likely to starting falling again sooner rather than later as US interest rate hikes become more imminent. In commodities, the Brent oil price has recorded small fluctuations at around 65 dollars/barrel. This lack of any decisive trend in the oil price can be attributed to OPEC's decision to keep its crude production quote unchanged as well as weak demand from emerging economies. In the medium term, we place the price range for a Brent barrel at 70-80 dollars.

Emerging countries: new foreign portfolio investment

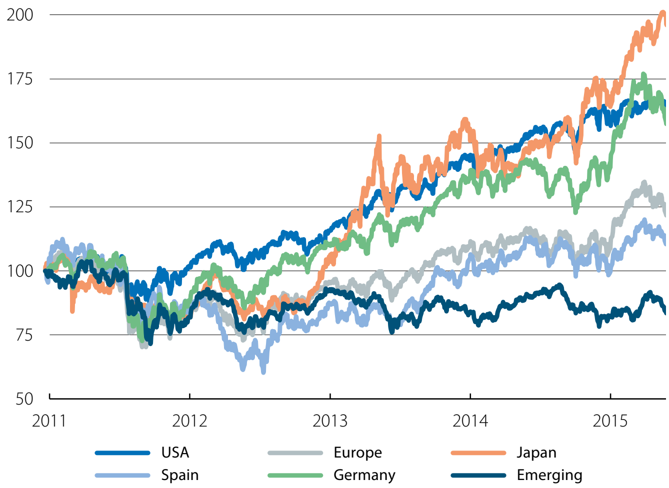
(Billion dollars)



Source: *"la Caixa" Research, based on data from the IIF.*

Main international stock markets

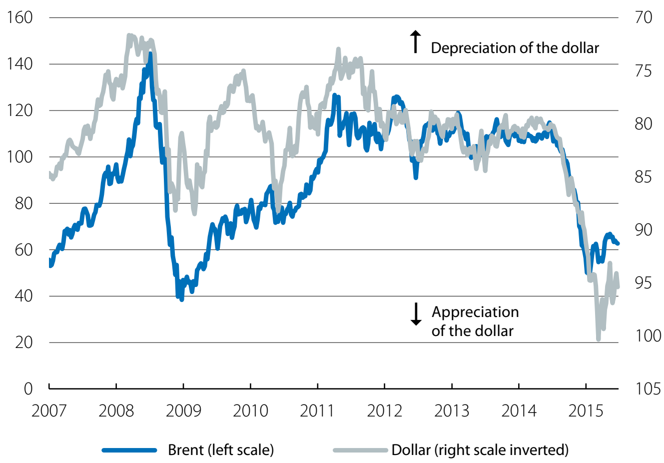
Index (100 = January 2011)



Source: *"la Caixa" Research, based on Bloomberg data.*

*Brent oil price and dollar index value **

(Dollars per barrel) *Level*



Note: ** Dollar's value compared with the currencies of its main trading partners.*
Source: *"la Caixa" Research, based on Bloomberg data.*