2007 strategic report

BBVA Global Markets believes stock exchanges will continue to prosper in 2007

- **In 2007 the prominent economic and financial factors will be high liquidity, buoyant earnings, the expansion anticipated in private equity and M&A activity, fostered by the sustainability of the global cycle**
- **The unit expects earnings to grow 10% in the USA, 12% in Europe and 15% in Japan**
- **Next year it expects the IBEX 35 to increase by about 10%, the S&P 500 by 11%, the EuroStoxx 50 by 14% and the Nikkei by 18%**
- **BBVA Global Markets expects emerging markets to continue their positive performance in 2007**
- **Latin-American stock exchanges will remain attractive and could rise more than 12% next year**
- **BBVA Markets unit favours financial and technology sectors in the euro-zone**

BBVA Global Markets unit predicts stock exchanges will continue to prosper in 2007 and believes securities have room to continue higher, despite the rises in 2006. It is expecting a 10% rise in the IBEX 35, 11% in the S&P 500 and 14% in the EuroStoxx. It bases its forecasts on new factors sustaining the current economic and financial environment. These are high liquidity, the sustainability of the global cycle, the expansion anticipated in private equity and M&A activity, and company earnings, which should enjoy double-digit growth.

In 2006 the world's economy grew at around 5% and stock exchanges rose 20% despite macro imbalances, the possibility that some stocks may be overvalued and the increase in geopolitical risk. BBVA Global Markets believes a new economic and financial model is needed to understand the prolonged bonanza. This model is based on three factors.

The first is the existence of a more global economy. About 40% of invoices received by companies in the EuroStoxx50 come from outside Europe. And a large percentage of costs are being outsourced to reduce unit labour costs.

Second, markets are increasingly global and new players are appearing (hedge fund and private equity). Furthermore, there are new products for the transfer of lending risk and leveraging (LBOs) and new management techniques for pension funds. These developments are generating violent swings in the markets and changes in the flow model. There is also greater releveraging of the banking system.

Third, there is greater integration between the economy and financial markets, and greater transparency and sensitivity of central banks with regard to market dynamics. Moreover, improvements in risk management at companies are reducing uncertainty about the future of the economy and the markets.

Key items for 2007

BBVA Global Markets believes the new economic and financial model has important implications for the three main arguments that support its forecast that stock exchanges will continue to prosper in 2007. These are:

- The new globalisation model, financial strength and high global liquidity mean the upward cycle is sustainable, despite the risk of a recession in US housing.
- Improvements in risk management and financial innovation will allow high liquidity and low interest rates to persist in 2007, even though the growth cycle is in its fourth year.
- Companies are exhibiting a growing capacity for releveraging, which they can use to speed up corporate restructuring.

Growth in earnings

Regarding the global cycle, BBVA Global Markets believes the key lies with the US economy. The central scenario assumes a soft landing for the real estate sector in that country. “We expect growth of around 2.5% at the end of 2007 because the impact on consumption, caused by a slowdown in the housing market, will be offset by the strength of the financial system. Structurally low interest rates and more moderate oil prices will also contribute”, says BBVA Global Markets’s strategic report.

According to this analysis, the risk of a sharp slowdown in the US economy is fading. This should be compatible with consolidation of the growth cycle in Europe and Japan, especially when emerging economies are still expecting strong growth without excessive imbalances.

Furthermore, at a time when the earnings of listed companies are increasingly global, revenues will remain relatively solid, leading to an important increase in profits in 2007. “Company earnings will rise 10% in the USA, 12% in Europe and 15% in Japan”, says the report.

Low cost of finance

High global liquidity is not the only factor helping to keep the volatility of most financial assets (securities, interest rates, lending, etc) structurally low. Central banks are also adapting their response to the new scenario. Apart from inflation and economic growth, central banks have turned their attention to the impact of liquidity on the value of fixed assets (property, commodities, etc), on lending and on overall leveraging of the banking system.

In this scenario, long-term rates have little room to rebound and this should keep volatility structurally low. The ECB will probably continue increasing rates to 3.75% and therefore the yield on the 10-year European bond should end the year at 4.20%, some 45 basis points higher than current levels. Interest-rate volatility should therefore remain at minimum level.

“In these conditions, companies will continue to make decisions assuming low interest rates and low volatility. This is a key factor for the creation of corporate value and will therefore affect share prices", says BBVA Global Markets.

Room for debt

Solid earnings, together with very low capital costs, provide ideal conditions for private equity deals and leveraged buy-outs. Although the volume of M&A has returned to the record levels of 1999-2000, two clear differences make the current process more sustainable:

- Companies have strong balance sheets with indebtedness substantially below the long-term average.

- The cost of capital in the euro zone is now more favourable for M&A activity due to the low cost of debt (2.50% in real terms), compared to the cost of equity (about 7%). This generates opportunities for creating value via re-leveraging.

“This analysis shows we have entered a phase of gradual improvement in share prices. Despite rising for four years, these are still below long-term averages (12-month-forward PERs are 12.75 compared to a euro-zone average of 15.41)”, according to BBVA Global Markets.

Goals and strategy for 2007

The interaction of these forces, together with the expectation of a gradual shift in global liquidity from real estate assets to stock exchanges, is sufficient to justify an increase of 1% to 3% in PERs in OECD countries in 2007.

If we add the rise associated with trading multiples and earnings to the stable outlook for exchange rates (with moderate depreciation in the euro/dollar rate), in 2007 the Nikkei could rise 18% (target of 19,200), the EuroStoxx50 could increase 14% (to

4,700), Wall Street could gain 11% (with the S&P500 at 1,560) and Spain could rise 10% (bringing the IBEX 35 to 15,450).

According to BBVA Global Markets, the strength of the cycle and the expectation of more moderate growth in commodity prices will be relatively favourable for Asia, with China playing a growing role. In this regard it should be noted that profit at Chinese companies in the first 11 months of 2006 has increased about 30%.

Moreover, relative prices and the possibility of lower interest rates in 2007 mean Latin America remains attractive, with share prices expected to rise more than 12%. Brazil and Mexico will continue to lead the upward trend on Latin-American exchanges, according to BBVA Global Markets.

“Apart from geographic diversification, in 2007 we expect sector diversification to play a growing role. This unit favours the financial and technology sectors. In both sectors, companies enjoy good profit momentum and considerable potential for M&A activity. Telecom operators could replace utility companies. They are accumulating value and greater confidence in their numbers is slowly emerging", says the report.

The products BBVA Global Markets recommends to customers include basic and structured products to round out the value chain. Apart from the management aspect, these take into account expected volatility and correlation with other factors. “Trinity” is an example of this type of product. It takes advantage of geographic diversification, favouring the Nikkei and Europe rather than the US.

The unit also expects hedge-fund business to do well and even improve on the returns achieved this year. “We recommend strategies linked to stock exchanges (such as Equity Long/Short, which focuses on relative value and management) and strategies based on corporate events such as M&A", the report concludes.