Mexico Weekly Flash

Next week…

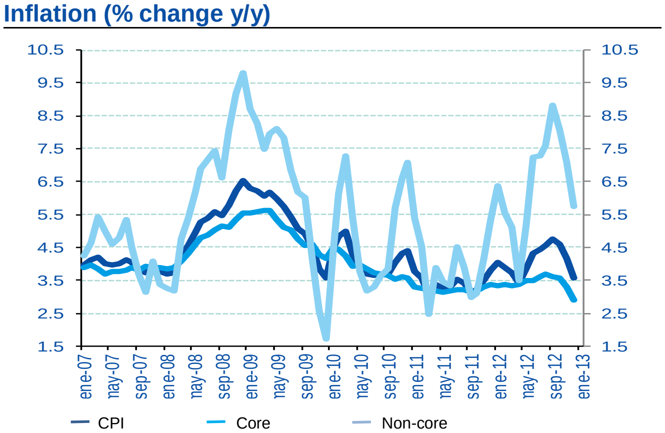
- **First inflation figures set to confirm continued positive performance**

  Next Thursday sees the release of the first inflation figures for the year which are set to show the shocks affecting inflation for much of 2012 have continued to dissipate. This is due to improved domestic output of commodities such as maize, beans and, to a lesser extent, eggs, stability and, in some cases, a decline in global grain prices, and a stable oil price. In addition to this, recent months have seen a stronger pesos and major falls in cell phone service prices. Goods prices as part of core inflation have begun to see lower inflation thanks to lower pressures on both processed foods and goods. As for service prices, although there is some uncertainty as to whether cell phone service prices will continue to decline in coming months, these falls are not expected to reverse. Furthermore, January is likely to continue to see a positive performance with the start of the low season for domestic tourism, placing downward pressure on domestic prices in the industry. Despite the major improvement in the inflationary balance risk, we believe there are still some risks that could place upward pressure, e.g. rates set by local government are expected to see higher inflation since regional governments could rely on increasing these prices to boost public finances, as seen in some states where the subsidy for owning a vehicle has been reduced or removed. We believe the inflation outlook at the start of 2013 is encouraging thanks to no supply shock being visible at the moment and the economy's slack avoiding demand price pressure. This is in addition to possible new price drops in the telecommunications sector.

- **Downward curve performance consolidates after *dovish* Banxico statement**

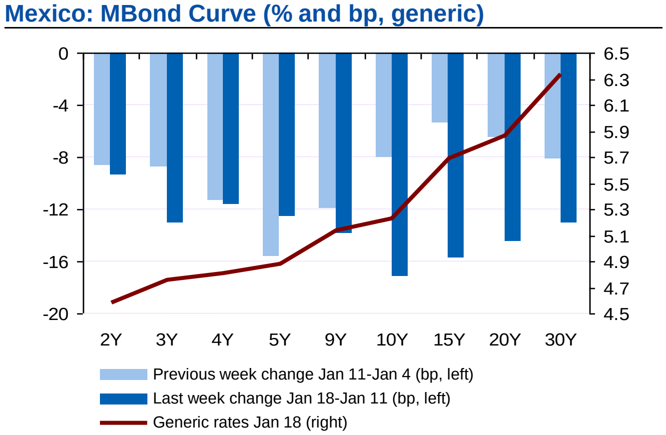
  After a much more accommodating monetary policy statement than expected by markets, the downward move in the MBonds curve and Cetes curve strengthened on Friday. While the market sees positive probability for a downward move, the rally across all curve section could continue. The MXN weakened at the end of the last week not only due to expectations from the statement but also to profit taking after the rally seen over recent weeks.

Chart 1
Inflation (% change y/y)



Source: BBVA Research with INEGI data

Chart 2
Mexico: MBond Curve (% and bp, generic)



Source: BBVA Research and Bloomberg

Calendar: Indicators

Inflation for the first two weeks of January (January 24)

Forecast: 0.39% bi-weekly (3.46% y/y)	Consensus: 0.32% m/m	Previous: -0.23% m/m, 3.57% y/y

Unemployment Rate in December (January 21)

Forecast: 4.8% of EAP, SA	Consensus: 4.8%	Previous: 5.1%

IGAE in November (January 24)

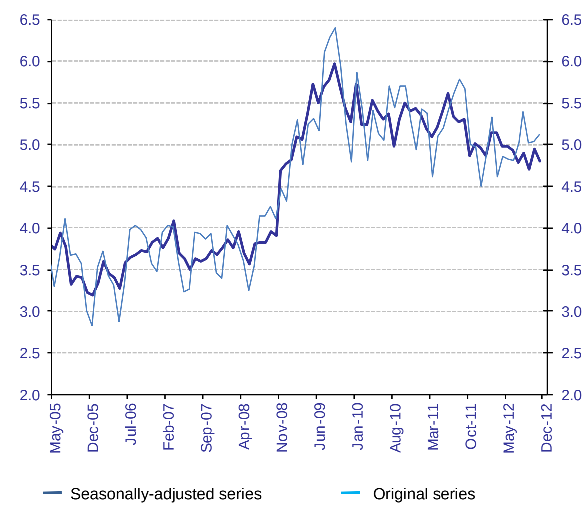
Forecast: 0.5% m/m, 3.1% y/y, SA	Consensus: 3.4% y/y NSA	Previous: 0.2% m/m, 2.8% y/y

Retail Sales in November (January 23)

Forecast: 1.5% m/m, 2.3% y/y, SA	Consensus: 2.9% y/y, NSA	Previous: -0.1% m/m, 3.0% y/y

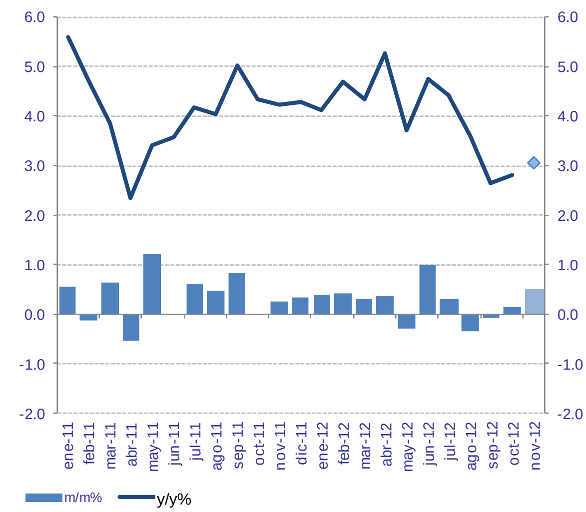
This week sees the release of output indicators that will outline economic performance at the end of 2012. After the fall in industrial output in October, linked in the manufacturing component by the negative effects of hurricane Sandy which impacted some US states and the Mexican supply chain. Based on industrial output indicators in November, we know that the industrial sector rose in the month (0.9% m/m) boosted by manufacturing with the an upturn in foreign demand and specifically in branches such as transport equipment, food and drink and the chemical industry. We believe that services linked to manufacturing such as transport and storage services, business support or professional services will have seen an upturn in November. In turn, the continued improvement in employment (4.8% y/y in the last six months, 4.5% in the previous six) and stability in real wages will have been key for the recovery in November in retail sales and have a positive impact on the "El Buen Fin" program promoting retail sales. Lastly, the unemployment rate for December is set to have seen a continued slow recovery. Monitoring indicators linked to the job market will also be important such as the underemployment rate (those people available for and in need of working more hours than their current job allows, 8.6% of those in employment on average from January to November) and the rate for those in work in critical conditions (employed under 35 hours per week due to market conditions or over 35 hours with income below the minimum: 11.9% of those in employment).

Chart 3
Unemployment Rate % of EAP



Source: BBVA Research with INEGI data

Chart 4
IGAE (y/y % and m/m change, seasonally adjusted series)



Source: BBVA Research with INEGI data

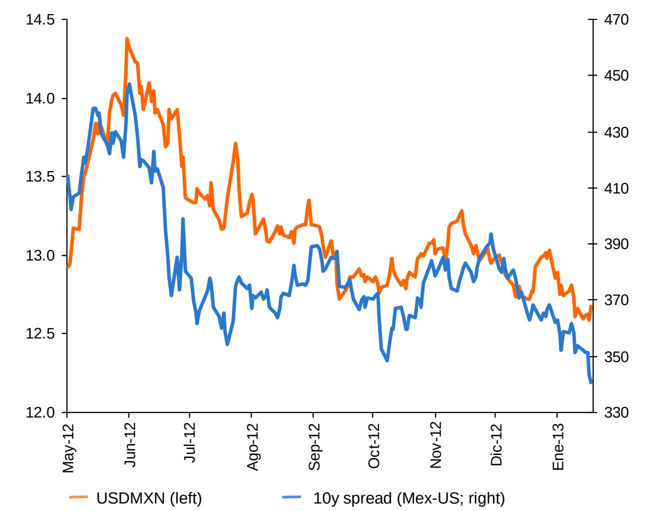
Downward curve performance consolidates after *dovish* Banxico statement...

The performance in domestic curves last week was set by expectations of less *hawkish* language at the Bank of Mexico monetary policy meeting. Nonetheless, the statement was much more expansionary than market expectations including a possible cut in the policy rate. In this way, the downward move in the MBonds curve and Cetes curve strengthened on Friday (with falls in the yield of around 9bp on average), thus accumulating around 15bp in the short sections and 20bp in the mid-section. Despite the change in tone in the statement, we maintain expectations of a monetary pause throughout 2013 given the current economic outlook. Nevertheless, if we consider that the market could start to factor in a cut, we continue to see space for an extended rally, especially in the short sections. In our opinion, FDI inflows will remain while the *carry* continues to be attractive, global liquidity injections continue and the outlook for Mexico continues to be optimistic. In this way, Banxico's language generally favors all sections of the curve.

...and the market takes advantage of the situation to take profits in the MXN

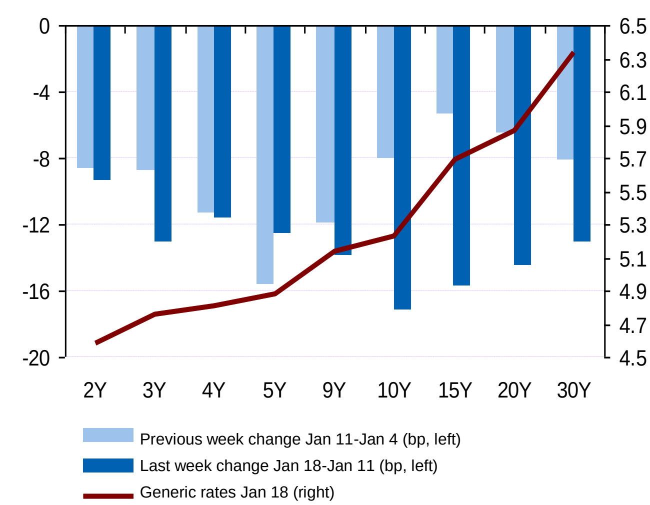
In turn, the MXN fell 0.7% at the end of the day. We already expected the move since beyond the effect of a possible rate cut, we believe the rally seen over recent weeks is about to come to an end. The market has favored the currency in regard to its peers and G10 currencies in the face of favorable expectations for domestic assets. Short-term external risks remain however and a possible more attractive valuation has still not materialized. We also stress the extremely long MXN position on the CME and the vulnerability to any negative news. In this sense, we believe the language was a trigger for profit-taking and now await more attractive levels (around 12.80) to take long positions.

Chart 5
Mexico: 10-year rate spread and USDMXN (generic bp and ppd)



Source: BBVA Research and Bloomberg

Chart 6
Mexico: MBond Curve (% and bp; generic)



Source: BBVA Research and Bloomberg

Technical Analysis

IPC

Source: BBVA, Bancomer, Bloomberg

The IPC ended the week with technical over-buying readings on the RSI oscillating indicator, trading slightly above the 10-day rolling average. We reiterate the upper section for this channel sitting right on 45,000pts. We await the index showing a major adjustment in coming weeks.

We recommend waiting to take positions as we believe the market may show this natural adjustment in the upward trend. We confirm possible supports at 43,000pts, 42,000pts and, in the worst case, 41,200pts.

Previous Rec. (01/11/13): We recommend favoring short-term liquidity and waiting for the market to show this natural adjustment in the upward trend

MXN

Source: BBVA, Bancomer, Bloomberg

After sending our buy signal on January 14 at the MXN12.59 level and supported by over-selling technical reading levels on the RSI and CCI indicators, we recommend holding positions and set our target price at MXN13.10

Previous Rec. (01/11/2013): The dollar breaks MXN12.70 over the week, a level where it had found support on several occasions since September, where the 10- and 30-day rolling averages sit.

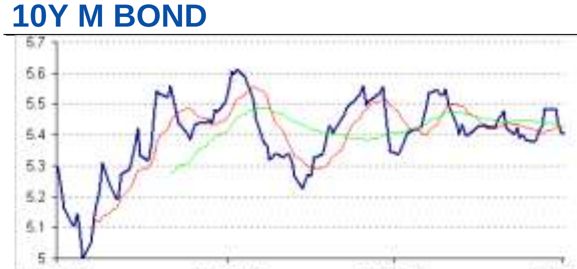
3Y M BOND

Source: BBVA, Bancomer, Bloomberg

3Y M BOND: Despite returning slightly below its stop loss at 4.85%, we recommend maintaining positions awaiting a positive bounce, given the readings on the technical RSI oscillator in the over-buying zone at -161pts.

Previous Rec. (01/11/12). We could expect a new bounce toward 5% with a stop loss at 4.85%.

10Y M BOND



Source: BBVA, Bancomer, Bloomberg

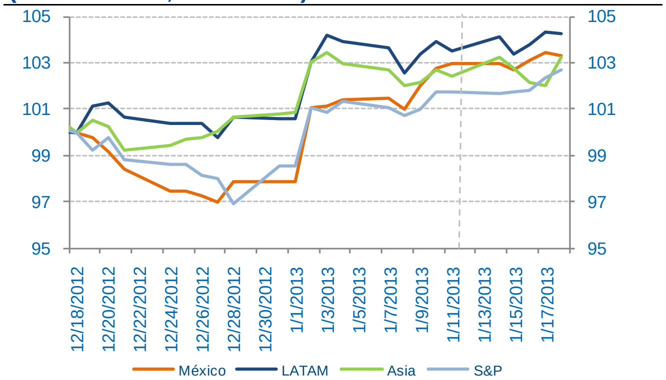
10Y M BOND; We take positions at the 5.2% level given the technical over-selling readings and set the target at the 200-day rolling average at 5.5% and the stop loss at 4.9%.

Previous Rec. (12/3/12). The bond is trading in an upward triangle formation that could set off a buy signal.

Markets, activity and inflation

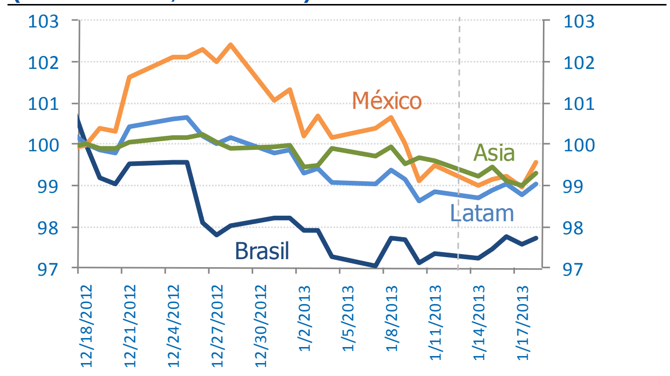
- **The Banxico statement offers up a surprise with a more expansionary tone than expected and leads to a fall in the peso and interest rates at the end of the week. Over previous days, better-than-expected housing start figures and unemployment benefit applications in the US led to a stronger peso and gains on stock markets.**

Chart 7
Stock Markets: MSCI indices (December 18, 2012 = 100)



Source: Bloomberg & BBVA Research

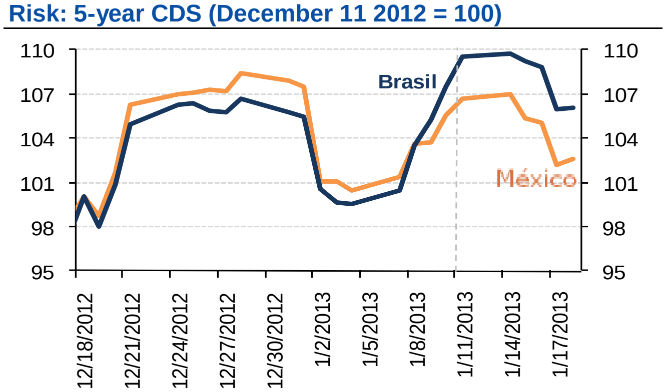
Chart 8
Foreign exchange: dollar exchange rates (December 18, 2012 = 100)



Source: Bloomberg and BBVA Research Note: LATAM includes Argentina, Brazil, Chile, Colombia and Peru. Asia includes the Philippines, South Korea, Taiwan, Singapore, Indonesia and Thailand.
Non-weighted averages

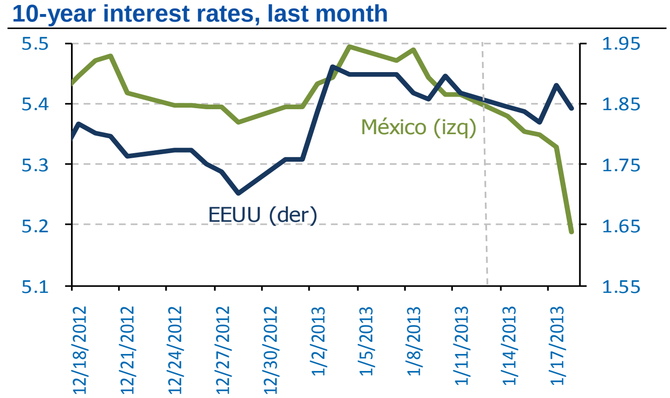
- **Fall in rates in Mexico to their lowest levels since July 2012 in the face of a possible rate cut by Banxico set out in its statement. The CDS level for Mexico reduces and remains below its 2012 average.**

Chart 9
Risk: 5-year CDS (December 11 2012 = 100)



Source: Bloomberg & BBVA Research

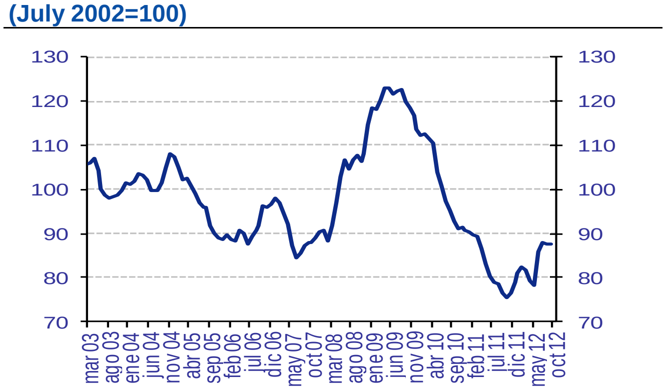
Chart 10
10-year interest rates, last month



Source: Bloomberg & BBVA Research

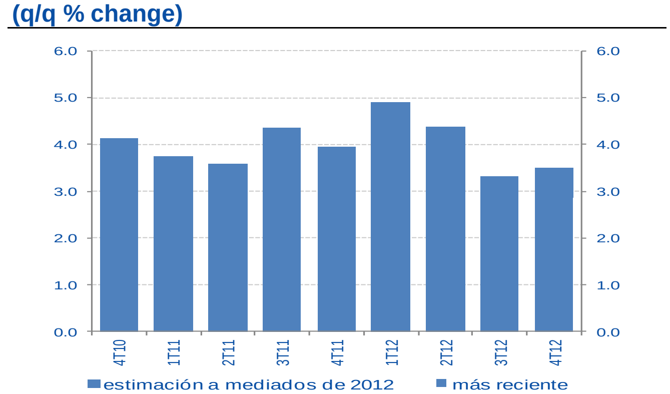
- **Recent situation indicators for economic output point to the last quarter having seen good growth meaning an annual average for 2012 slightly above 3.7%. In the meantime, inflation fell, coming in under 4% in December.**

Chart 11
Inflation Surprise Index (July 2002=100)



Source: Bloomberg & BBVA Research

Chart 12
Observed and estimated GDP (q/q % change)



Source: BBVA Research with data from Bloomberg

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