Mexico Weekly Flash

Next week…

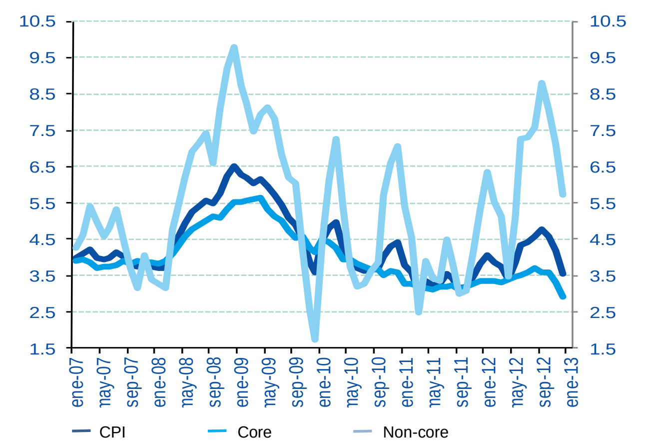
- **Inflation continued to slide in January**

  Next Thursday sees the release of inflation figures for January, which we estimate will be around 0.26% m/m, with an annual rate of 3.1% y/y. This is a major drop in comparison to the 3.57% y/y recorded in December. This good result comes from good performance in both core and non-core inflation. Core inflation should show the impact from a major decline in inflation for goods due to price stability in grains and the higher peso and for services due to the low stable inflation linked to housing costs and the start of seasonal offers in the tourist sector. Non-core inflation should show benefits from the lack of agricultural price pressure and the fixed public sector rates. In this sense, inflation continued to decline in the first month of the year, leaving room to absorb any shocks in the rest of 2013, such as higher domestic prices for agricultural products, higher rates set by local governments, another decline in the peso or new supply shocks on global commodities markets. Nonetheless, we forecast inflation remaining below 4% throughout the year and to come in around 3.6% y/y at year-end.

- **Banxico seems to be considering a cut, although uncertainty surrounding inflation convergence remains**

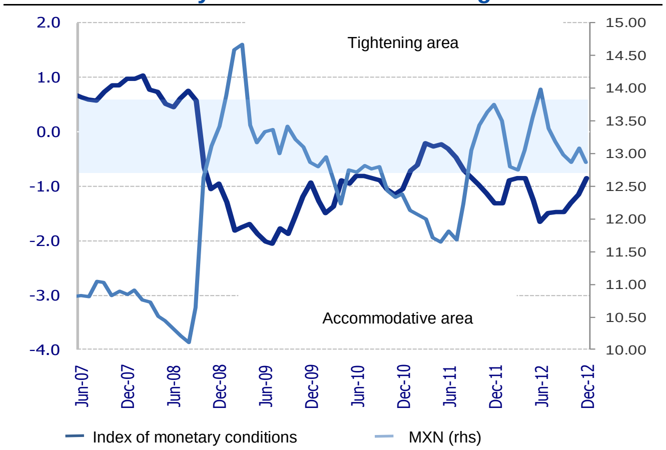
  As on previous occasions, the monetary policy decision minutes from January 18, released today, confirm that most Board members seem inclined to cut the rate if the downward inflationary trend is confirmed. Most maintained similar arguments to those seen in the minutes from March 2012 and stated that convergence could come at a lower economic cost. (cont. on page 3)

Chart 1
Inflation (% change y/y)



Source: BBVA Research with INEGI data

Chart 2
Index of monetary conditions and exchange rate



Source: BBVA Research with Banxico and Bloomberg data

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Calendar: Indicators

January inflation (February 7)

Forecast: 0.26% m/m (3.1% y/y)	Consensus:	Previous: -0.23% m/m, 3.57% y/y

Consumer Confidence in January (February 6)

Forecast: 0.3% m/m, 99.8 pts	Consensus: N.A.	Previous: 2.3% m/m, 99.5 pts

Producer Confidence in January (February 6)

Forecast: 0.8 m/m, 56.7 pts	Consensus: N.A.	Previous: 1.2% m/m, 56.3 pts

Consumer and producer confidence indices to be released on February 6 are set to confirm the positive sentiment among consumers and producers regarding expectations on the economy's status in coming months. It should be stated that consumer confidence recovered in the last three months and although still below pre-crisis levels in 2009 in terms of the level, the improvement in confidence in recent months was among the highest recorded. This good moment for confidence is linked, in turn, to continuous job openings in the formal private sector with growth above 4.5% y/y in the last 12 months. It also points to the solid nature in domestic spending indicators at the end of 2012, seen for example in retail sales (3.5% change y/y between September and November, 4.2% in the last 8 months on average) and should lead to good private consumption growth in the last quarter of the year.

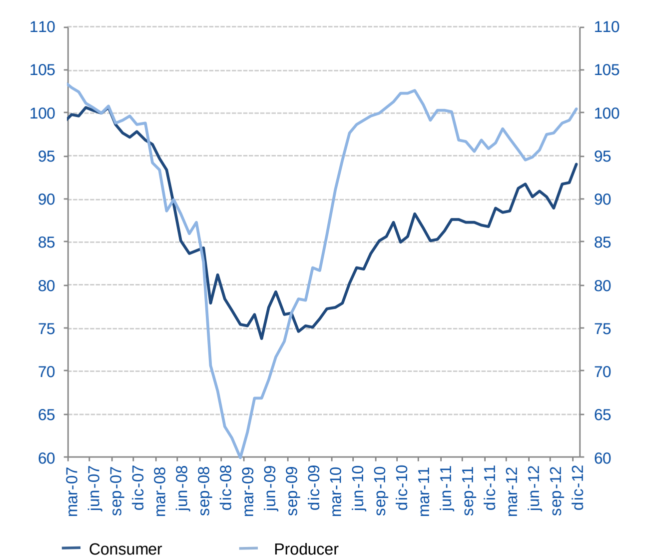
In turn, we estimate producer confidence will continue improving mainly due to components linked to the trend in manufacturing sectors for export and, to a lesser extent, in domestic demand for products. The IMEF Manufacturing indicator for Mexico which serves as a forward indicator for manufacturing output points to production in the industrial sector having continued to improve in the last months in 2012 and the first month of 2013.

Investment in November (February 8)

Forecast: 0.7% m/m, 5.8% y/y	Consensus: N.A.	Previous: -0.3% m/m, 6.6% y/y

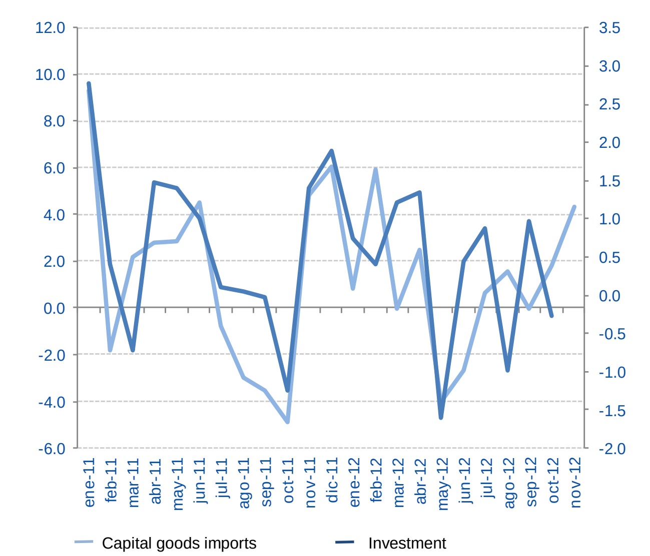
Investment in November is set to show a recovery after the decline in October (-0.3% m/m). Information on the import component for investment showing growth of 17.6% y/y in November points to investment in machinery and equipment having progressed at a good rate toward the end of the year; nevertheless, doubts remain about investment in construction since it should be recalled that output in the sector contracted by (-)0.1% y/y in November.

Chart 3
Confidence: Consumer and Producer (July 07 = 100)



Source: BBVA Research with INEGI data

Chart 4
Investment and Capital Goods Imports (% change y/y)



Source: BBVA Research with INEGI data

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(continued from page 1)

Nonetheless, one member saw it as very early to send signals of a rate cut due to there being no information on how long-lasting the downward inflation trend will be. This opinion comes from the fact that the decline in inflation in recent months crucially rested on lower telecommunication rates which could be temporary.

We maintain our outlook for a monetary pause in coming months based on the following: 1) the different opinion on the Board regarding the level and time that inflation needs to remain around the target for convergence to be confirmed, 2) our outlook that inflation will not hit the target in the short-term, and 3) persistent medium-term inflation estimates of around 3.5%. If inflation did remain at the target for several consecutive months, however, the chances of a 50bp cut increase. This is due to the stance of some Board members who believe the cut should only be made to show the gains made in fighting inflation and the fact that real rates have not been negative for a prolonged period in the last decade. In turn, if the MXN remains on an upward path and/or economic pace continues to slow, there would be margin for a cut in the current inflationary context.

In this scenario, what strategy should be followed?

We reiterate our current recommendation that involves taking the TIIE 1-year rate (although the 2-year also has value) but we have moved our stop loss to the 4.90 entry level and lowered our target to 4.50 from the initial 4.70. We will also continue to follow our strategy of extremes (butterfly) for Mbonds: 3Y and 30Y long vs. the 10Y, open in July 2012. Although the likelihood of a rate cut will continue to favor the short end of the curve, we are sure Banxico will not raise the lending rate in the long-term. Therefore, the long section is highly likely to remain in demand.

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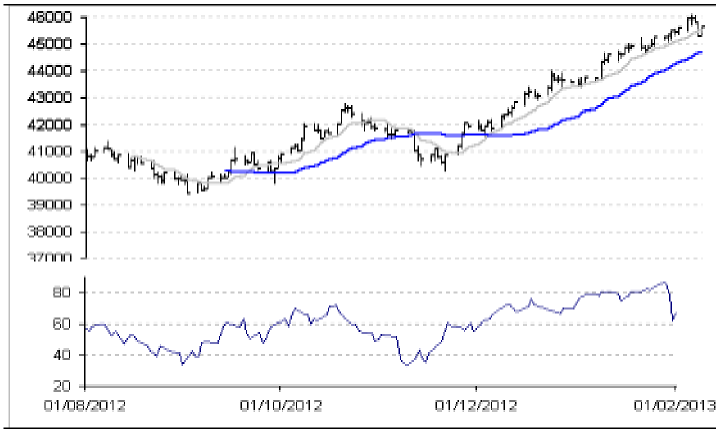
Technical Analysis

IPC

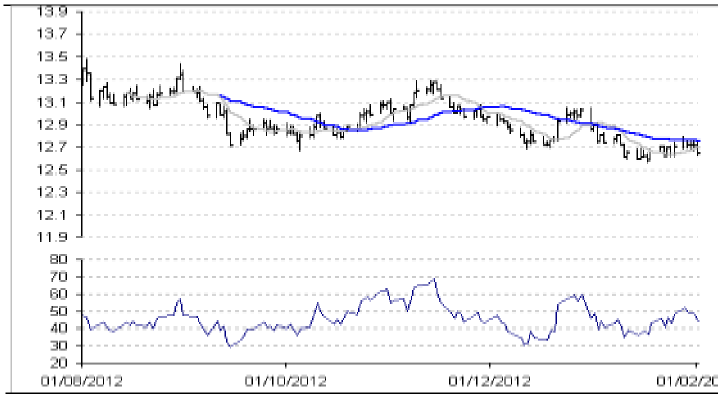


It would seem the 46,000pts level could finally set a ceiling for the short-term upward move on the IPC. The neutral balance of the IPC led the market to position slightly below the short-term trend line where it had been trading since the bounce from 40,500pts started. The next IPC floor level could be taken at the 10-day rolling average (45,541pts), right where it ended the week. If the IPC finally manages to break down through the 10-day rolling average, using the Fibonacci retracement model, we could take the resistance at 44,700pts and then at 43,500pts. This weakness signal would reverse if the market again moves up and breaks the 46,000pts level. This would lead it to seek levels above 46,500pts.

Previous Rec (1/28/13): If the IPC rebounds again in the 10-day rolling average and breaks up through 45,500pts, we can consider the next level of resistance at 46,200pts

Source: BBVA, Bancomer, Bloomberg

MXN

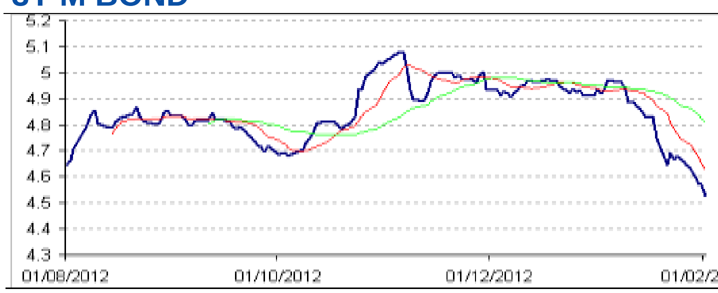


The dollar found resistance at the 30-day rolling average and is signaling a possible return again to the MXN12.55 zone. This support continues to be strong seeing as it is the minimum from last year.

Previous Rec (1/28/2013): We believe that this upturn could find resistance levels at MXN 12.76 or even at MXN12.90, where 10-day and 30-day rolling averages are trading.

Source: BBVA, Bancomer, Bloomberg

3Y M BOND

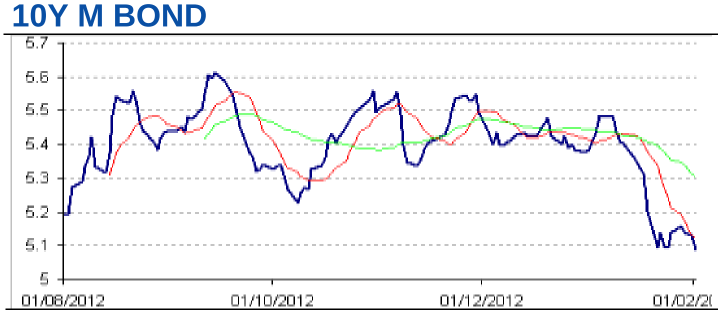


3Y M BOND (yield): The bond broke the previous floor and set off the stop loss. The next floor is up to 4.47%, the 2011 minimum. Upturns could find resistance at 4.6% and 4.8%.

Previous Rec. (1/28/13). We expect a rebound to 4.8%.

Source: BBVA, Bancomer, Bloomberg

10Y M BOND



10Y M BOND (yield): The bond remains in the same range as the previous week and we maintain long positions. This will continue as long as it does not break downward through 5%.

Previous Rec. (12/3/12). With the RSI showing buy, we expect a rebound towards 5.2% and subsequently 5.38%.

Source: BBVA, Bancomer, Bloomberg

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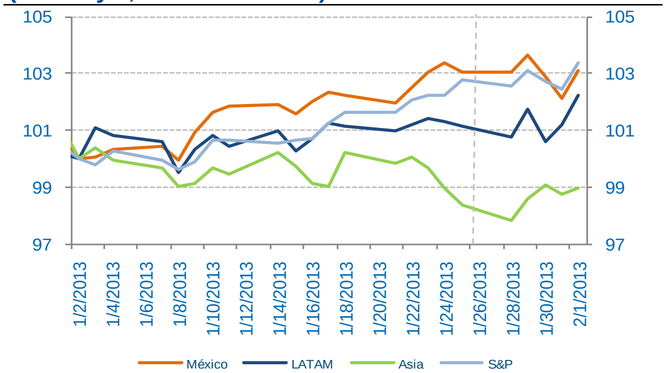
Markets, activity and inflation

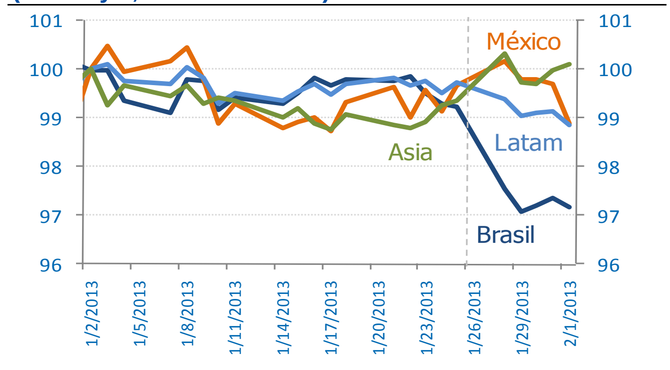
- **An upward revision in US jobs figures, as well as a FED statement signaling monetary stimulus will continue, have a hand in the exchange rate strengthening and a upswing on stock markets at the end of the week.**

Chart 7
Stock Markets: MSCI indices (January 2, 2013 index=100)



Source: Bloomberg & BBVA Research

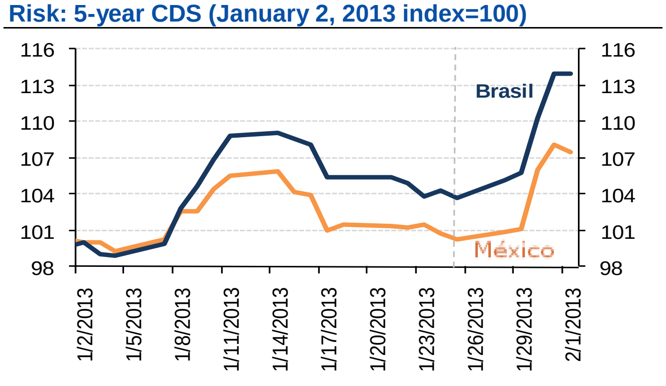
Chart 8
Foreign exchange: dollar exchange rates (January 2, 2013 index=100)



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

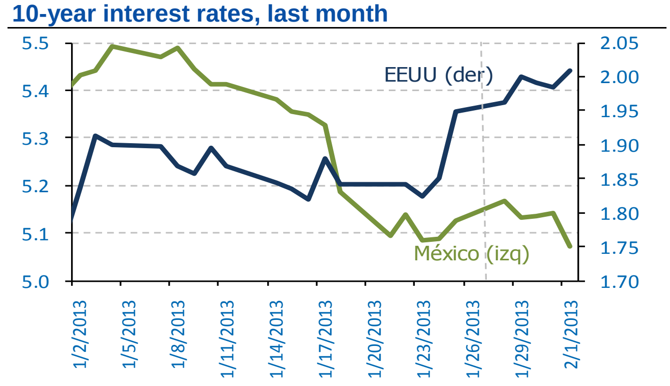
- **Increase in US interest rates due to greater appetite for risk thanks to jobs figures. Rates in Mexico fall at the end of the week due to Banxico monetary policy minutes confirming Banxico's accommodating tone. There was an increase in risk aversion mid-week influenced by lower US growth in 4Q12.**

Chart 9
Risk: 5-year CDS (January 2, 2013 index=100)



Source: Bloomberg & BBVA Research

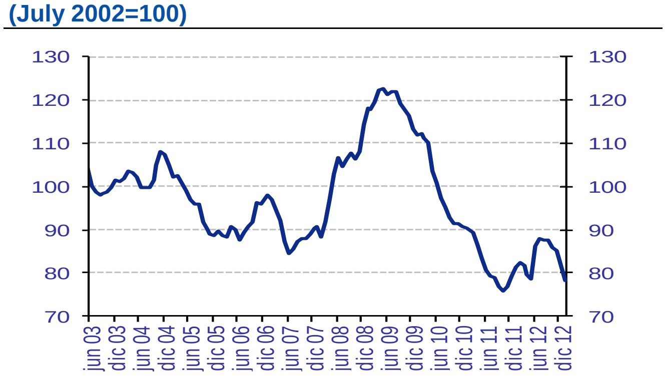
Chart 10
10-year interest rates, last month



Source: Bloomberg & BBVA Research

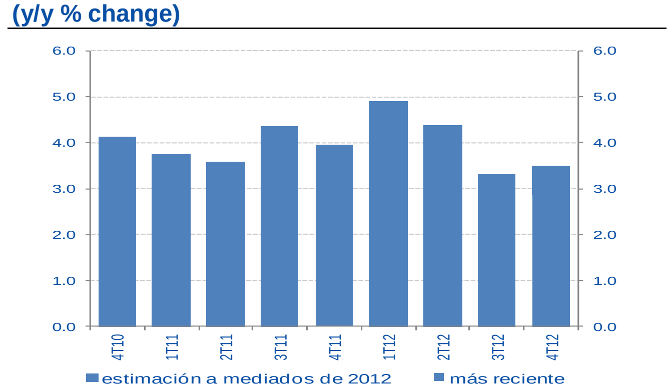
- **Recent situation indicators for economic output point to the last quarter having seen good growth meaning an annual average for 2012 around of 3.9%. In the meantime, inflation fell, coming in well under 4%.**

Chart 11
Inflation Surprise Index (July 2002=100)



Source: Bloomberg & BBVA Research

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



Source: BBVA Research with data from Bloomberg

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