Mexico Weekly Flash

Next week…

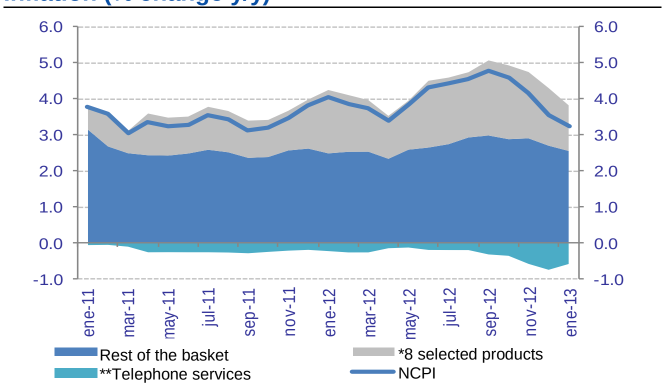
- **Inflation Report for 4Q12 set for release will help assess short-term inflation outlook**

  Banxico will release its inflation report for the last quarter of 2012 next week. Focus will need to be on the possible change the central bank may make to its inflation forecast given the major decline seen in November and December 2012, which meant it ended the year within the inflation target variability range. Both the size and possible changes in trajectory planned will be important in the new inflation forecast. They will provide information on how marked statistical effects could be throughout the year. In addition, it will be interesting to see if new information on the major decline in telephony inflation in Q4 is provided and whether this is seen as continuing into the future. With regard to output forecasts, we believe there will be minimal changes since there is not enough information to change the growth forecast of between 3% and 4% for this year. In this way, next week's report will undoubtedly be one of the most important events on the domestic economic agenda in a context where the Central Bank is again the focus of attention.

- **A week of high volatility for the peso.**

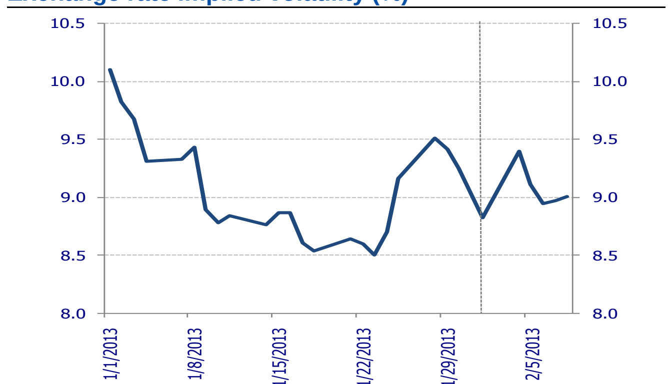
  This week the USDMXN rate saw high volatility due to several factors, both external and domestic. Firstly, new political storms in the EMU had a negative effect on risk assets while the market awaited the outcome of the European summit and the ECB board meeting. With regard to the latter, Draghi's speech mentioning the recent strength of the EUR (something to keep an eye on) added to factors behind profit-taking. The calendar of economic data was less charged and corporate reports did not contribute to renewed optimism. In short, the high liquidity setting continues and declines on stock markets and in other risk assets were used to again take long positions. On the domestic front, the lower-than-expected fall in inflation in January had a positive intraday impact. Nonetheless, the high currency beta meant the MXN weakened. (continued on page 3)

Chart 1
Inflation (% change y/y)



Source: BBVA Research with INEGI data. *Tortillas, chicken, beef, eggs, tomatoes, beans, gas and fuel (13.5% weight in the IPC basket of goods). ** **Telephone services include local, cell, national and international long distance services (3.26% weight in basket)

Chart 2
Exchange rate implied volatility (%)



Source: BBVA Research with data from Bloomberg

Calendar: Indicators

Industrial Output for December (February 11)

Forecast: 0.1% m/m (2.6% y/y)	Consensus: 2.0% y/y	Previous: 0.9% m/m, 3.2% y/y

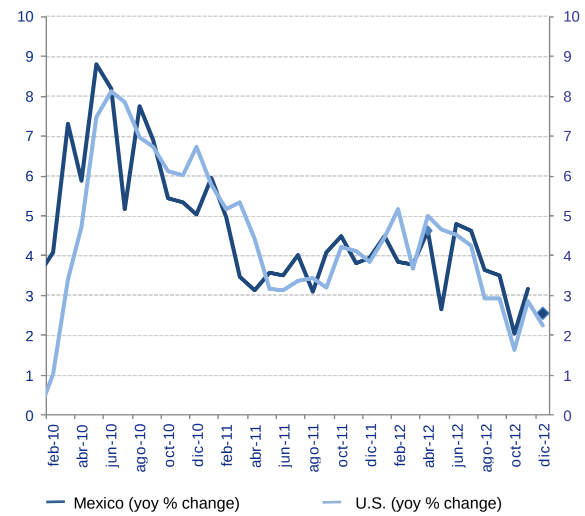
Manufacturing growth at the end of last year will confirm the slowdown in industrial output throughout 2012. We forecast a slight expansion of 0.1% m/m, 2.6% y/y (both seasonally-adjusted). Automotive output to the last month of the year fell nearly 10% m/m, eliminating the seasonal effect for the series, although compared with the same month from the pervious year, there was a slight increase (0.7%). Producer confidence indicators point to other manufacturing branches improving output, especially for exports. This is true for expected demand for business products from the foreign sector. In turn, US industry saw a slight expansion (0.3% m/m) and manufacturers 0.8%. Given the strong link to domestic manufacturing, this performance is in line with a slight slowdown at manufacturers. Progress or lack thereof in the construction industry will be important, having seen declines in three out of the last four months.

Strategic Indicators for Occupation and Employment for 4Q12 (February 12)

Forecast: 4.9% Unemployment rates	Consensus: N/D	Previous: 5.2%

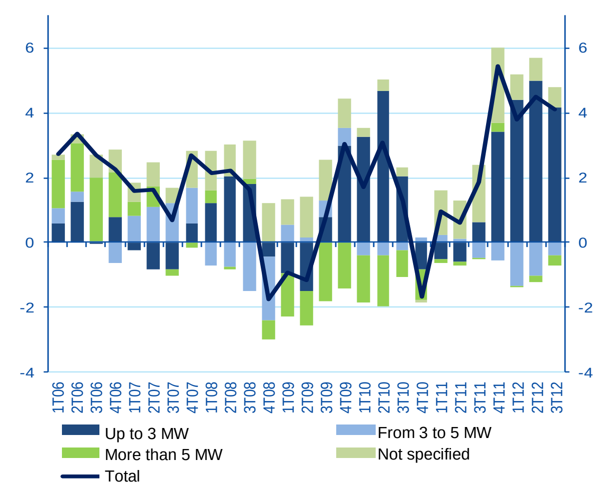
Strategic occupation and employment indicators will provide a fuller picture of the employment and unemployment situation at the end of the year. Thanks to monthly indicators, we know that the unemployment rate will come in around 5% but it will be useful to know related indicators such as the underemployment rate, which will continue to come in around 8.5% of the total population, or the employment in critical conditions rate (percentage of the working population doing less than 35 hours a week due to market reasons, plus those working over 35 hours a week with monthly income below the minimum wage and those working over 48 hours a week and earning up to two minimum wages), around 12% of the population. It will also be important to see the progress in terms of the labor force in the economy in the last quarter and the range of income. The previous quarter saw a predominance of low income employees.

Chart 3
Industrial output: Mexico and USA (% change y/y)



Source: BBVA Research with INEGI and Bloomberg data

Chart 4
Employment by income level (% change y/y and contributions)



Source: BBVA Research with INEGI data

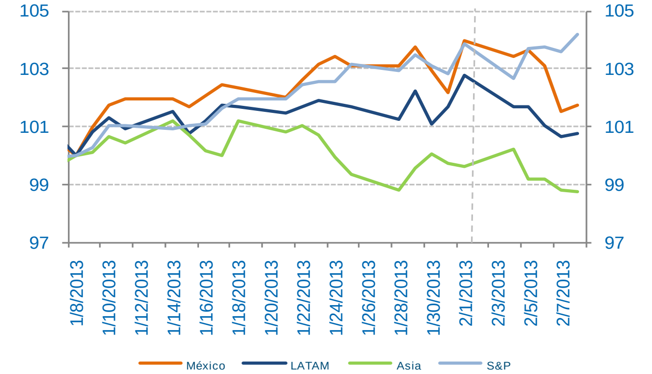
(continued from page 1)

However, the 12.62-12.80 range continues intact and, given the current scenario, should remain so in the short-term. After the inflation figures, rates have temporarily corrected the major decline in previous weeks. The market continues to watch out for the chance Banxico cuts its policy rate. In this way, at these levels curve volatility saw major increases - a factor that will surely continue to set the market trend. We continue to recommend remaining short in the medium section vs. long sections. In addition, the short sections should ease and return to levels 5-10bp lower.

Markets, activity and inflation

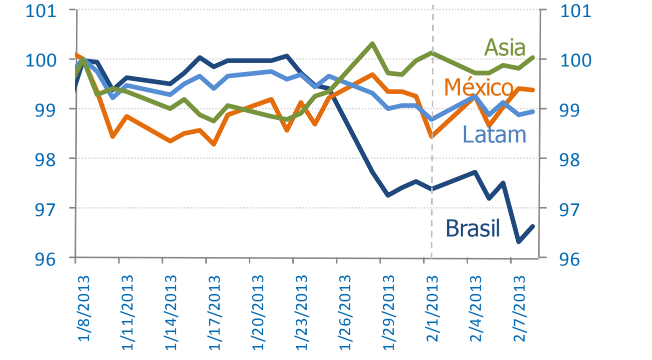
- **Toward the end of the week, the statement by the head of the European Central Bank on the strength of the euro possibly slamming the brakes on the Eurozone's economic recovery combined with a decline in labor productivity in the US and lower-than-expected corporate reports to trigger a decline on stock markets and a weaker peso.**

Chart 7
Stock Markets: MSCI indices
(January 8, 2013 index=100)



Source: Bloomberg & BBVA Research

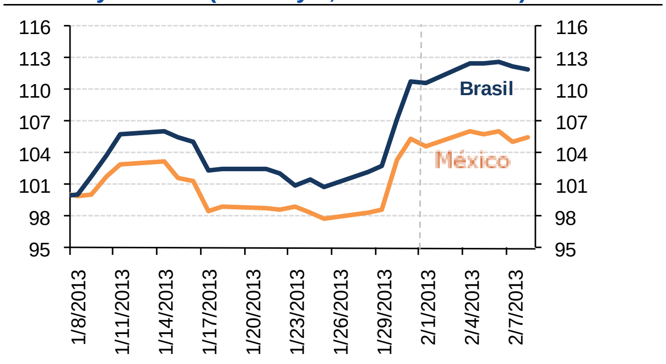
Chart 8
Foreign exchange: dollar exchange rates
(January 8, 2013 index=100)



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

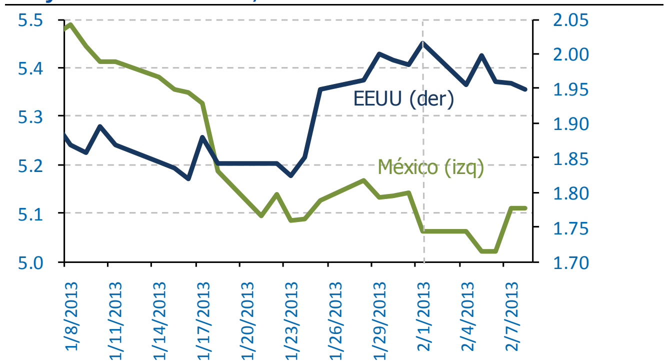
- **No major changes in global risk aversion, rates in Mexico rise toward the end of the weak and decouple from Treasury bonds after the fall in inflation in January came in below consensus forecasts.**

Chart 9
Risk: 5-year CDS (January 8, 2013 index=100)



Source: Bloomberg & BBVA Research

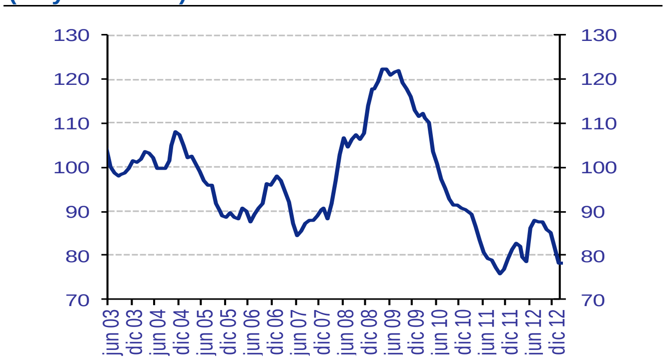
Chart 10
10-year interest rates, last month



Source: Bloomberg & BBVA Research

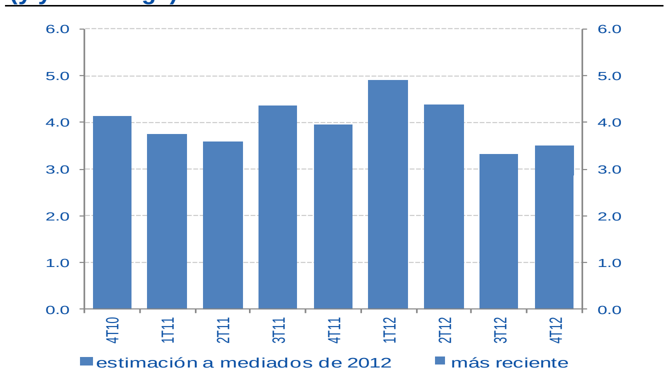
- **Recent situation indicators for economic output point to the last quarter having seen good growth meaning an annual average for 2012 around of 3.9%. In the meantime, inflation fell, coming in well under 4%.**

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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