Mexico Weekly Flash

Next week…

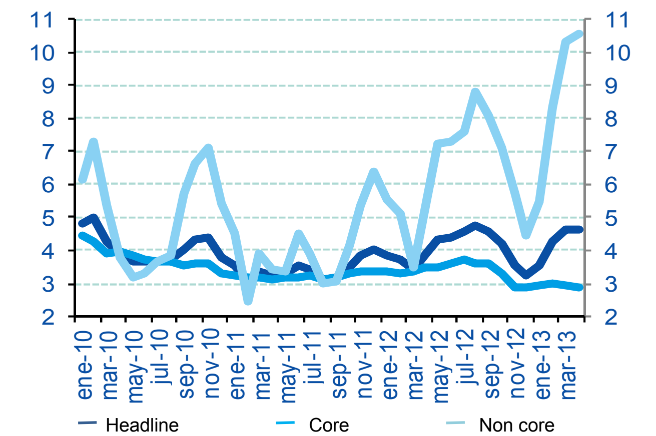
- **The inflation rate in the first half of the month will help us assess how long it will take to fall below 4%**

Inflation figures for the first half of June will be published on Monday 24. We believe that they will show a clearly downward trend, as inflation will drop from 4.62% in May to 4.4% in the first half of June. The decline is due to the fact that some non-core supply shocks, in particular within the sub-component of fruit and vegetable prices, have significantly eased in the last few weeks, offsetting the pressure on prices from livestock and public products. Core inflation will remain under 3% in the context of a slack economy, also supported by lower world grain prices and an exchange rate that has appreciated on average with respect to that in the first six months of 2012. As a result, inflation will begin to converge to 4%, supported by lower agricultural prices and the slack in the economy, but the time taken to reach the target range will depend on the performance of public and livestock prices, so these are undoubtedly the main prices to watch in the short term.

- **The FOMC meeting shakes up the financial markets**

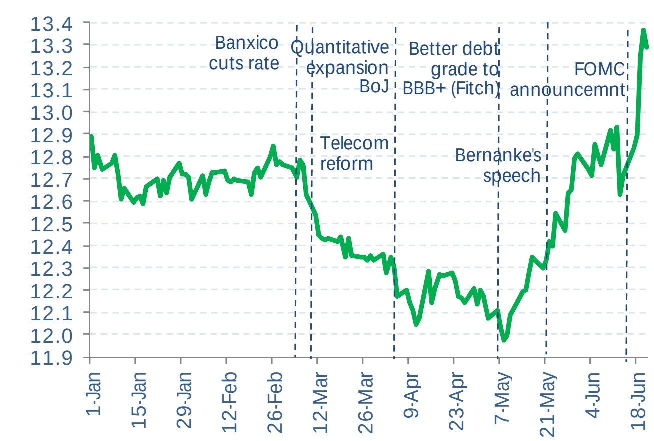
As we anticipated last week, whether the recent movements in financial variables will continue, gain strength or reverse depended on this week's FOMC meeting. In it, the Fed announced its intention of beginning to reduce the rate of asset purchases at the end of this year. This had an impact on the financial markets, as they have interpreted it as confirmation that we were on the threshold of the start to a gradual normalization of monetary policy in the U.S. Stock markets in developed and emerging economies fell drastically, Treasury bonds rose even more, the dollar gained, and commodity prices plummeted. In short, investors fled from risky assets. Mexico was no exception: during the week it reached highs of 12.45 pesos/dollar (closing the week at levels of around 12.30). The local curves weakened significantly, with the 10-year M-bond gaining by around 80 bps to a level of 6.08%.

Chart 1
Inflation breakdown (y/y % change)



Source: INEGI, Banxico, BBVA Research

Chart 2
Exchange rate (peso/dollar)



Source: BBVA Research and Bloomberg

Inflation 1st half June (24 June)

Forecast: 0.08% bi-weekly; 4.4% y/y	Consensus: 0.08% bi-weekly	Previous: -0.33% m/m; 4.62% y/y

April IGAE (June 25)

Forecast: 1.8% y/y (S/A)	Consensus: N/A	Previous: 2.33% y/y (S/A)

Given that the industrial output and retail sales figures were both lower than estimated, we consider that the IGAE will reflect the moderation in economic activity more clearly than in previous months.

It should be noted that industrial output fell sharply in April, with the second biggest fall since June 2009 in monthly terms, at -1.7% (-2.1% y/y in the seasonally-adjusted series). The fall was a result of contraction in three of the four components making it up. The manufacturing sector fell in April due falls in 15 of its 21 branches. The fall in branches such as transport equipment, drink and tobacco and the chemical industry are of particular importance due to their weight in the overall total.

The indicator of income from services rose in April 1.9% y/y, while retail sales fell by 0.9%, the biggest fall since 2009. There was also a notable contribution from services linked to the manufacturing sector, which could reflect a weakness in the tertiary sector, and imply a growth in the IGAE of around 1.8% y/y.

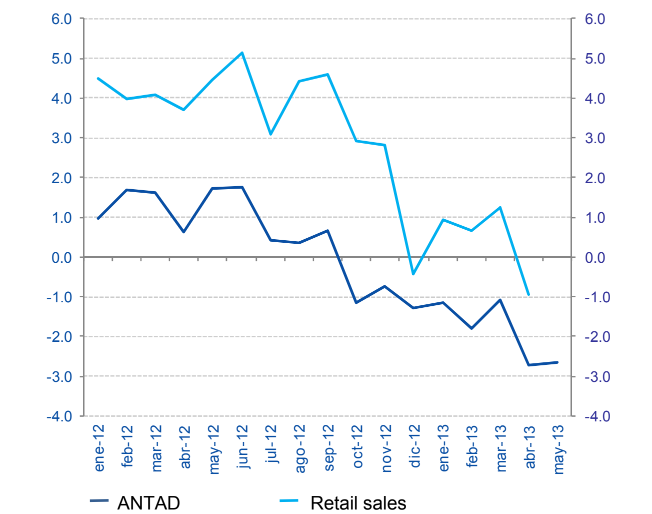
Trade balance in May (June 26)

Forecast: USD 1,654m	Consensus: USD 177.2m	Previous: USD -1,227m

Next Wednesday sees the release of the trade balance for May. We estimate that in terms of annual growth both exports and imports fell by around -2.5% and -6.6% y/y respectively. We consider that the trade balance was positive in May, as higher imports of intermediate goods in April undoubtedly anticipate an upturn in manufacturing exports; in addition, the energy balance will improve due to lower gasoline imports. We therefore estimate that the trade balance will remain close to zero, in line with the weak external environment and slack domestic demand.

Chart 3

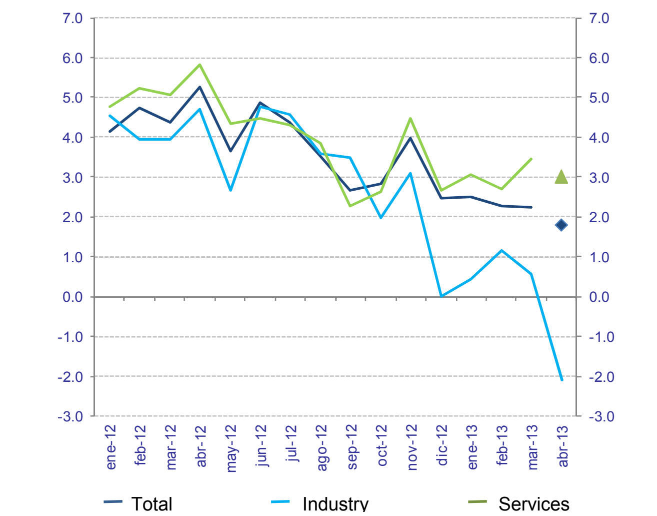
Retail sales and ANTAD (y/y % change)



Source: BBVA Research with INEGI data

Chart 4

IGAE and components (y/y % change)



Source: BBVA Research with ANTAD INEGI figures

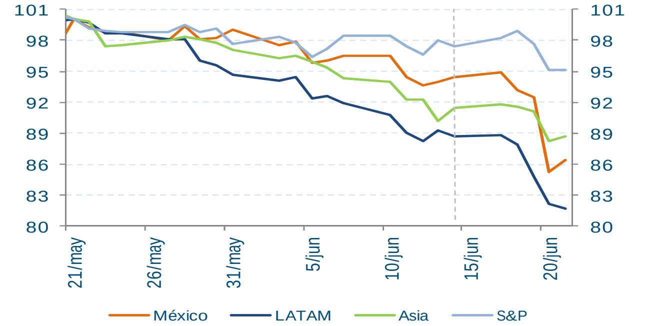
Markets

Last week the MXN hit highs of 12.45 and the local curves weakened significantly (the 10-year M-bond rose by more than 85 bps). All this is a result of the Fed factor, which continues and will continue to be the main determinant. The main risk is now related to other local assets. Flows into local fixed-income instruments have repeatedly broken through their all-time highs in the last two years, and this trend has gathered pace in 2013. Although the MXN may be one of the currencies that would benefit in the future from a more positive U.S. economic forecast, the continued mass sale of local assets could push the USD/MXN to new highs in 2013. This mass sale cannot be ruled out at present; the USTs continue to rise, and although the rate is slowing, if the trend in U.S. economic data began to be favorable, the market would incorporate higher levels of USTs in the future. If the local curves maintain the positive correlation with these assets in the medium term, it will depend on the weight given to structural reforms, within a more stable external environment with a reactivation in the search for carry trades. This appears unlikely in a context of a trend to revalue risk due to the changes in U.S. monetary policy. At present there are few factors to justify a return to the favorable trend recorded at the start of May (combined with the fact that prospects for the exchange rate are not encouraging). At present, the short end of the curve continues to be most affected and the renewed appetite for strategies expecting a steeper curve could continue.

Markets, activity and inflation

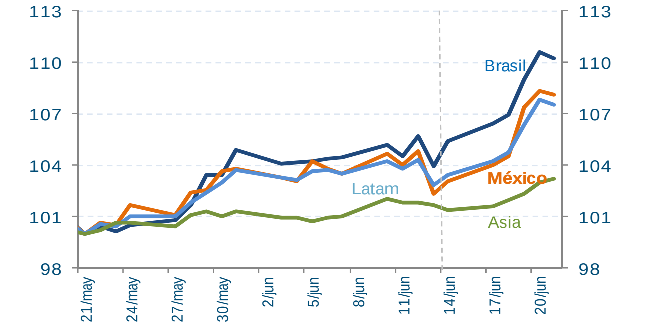
- The optimistic tone of the Federal Reserve's statement and the announcements by its chairman have led markets to anticipate the start of a withdrawal of the monetary stimuli, both in terms of asset purchases and expectations that a hike in the reference rate will come earlier than expected. As a result, there were falls in stock markets and depreciations in LATAM currencies of a level not seen since 2011.

Chart 7
Stock markets: MSCI indices (May 21, 2013 = 100)



Source: BBVA Research with data from Bloomberg

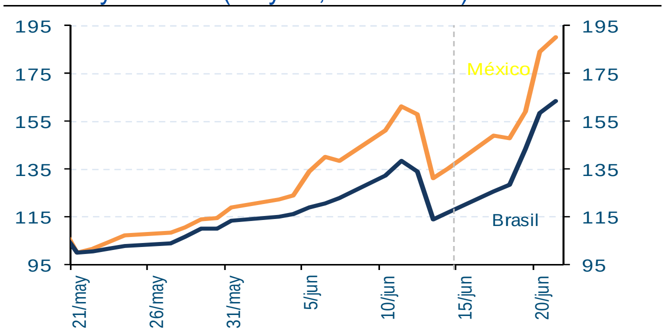
Chart 8
Foreign exchange: dollar exchange rates (May 21, 2013 = 100)



Source: BBVA Research with Bloomberg data NB: LATAM includes Argentina, Brazil, Chile, Colombia and Peru. Asia includes the Philippines, South Korea, Taiwan, Singapore, Indonesia and Thailand.

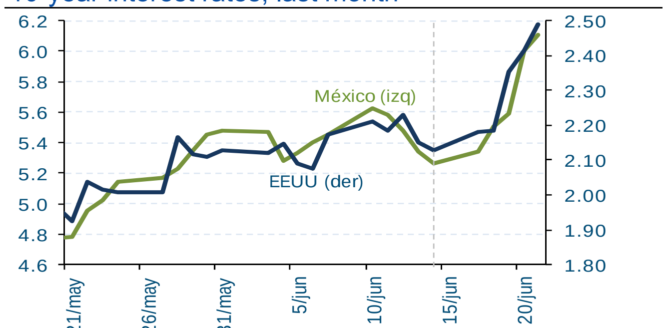
- General rise in risk aversion and interest rates in both the U.S. and Mexico as a result of a process of normalization in asset prices reflecting expectations of a withdrawal of monetary stimuli.

Chart 9
Risk: 5-year CDS (May 21, 2013 =100)



Source: BBVA Research with data from Bloomberg

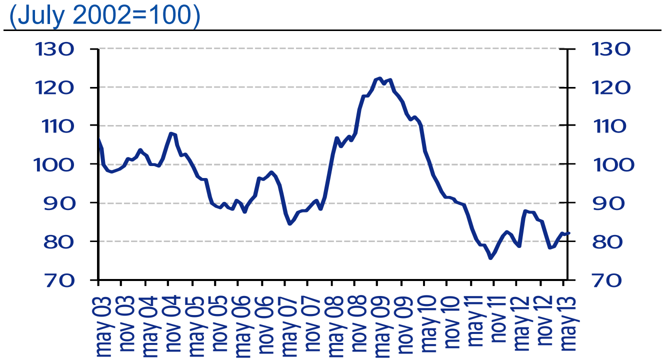
Chart 10
10-year interest rates, last month



Source: BBVA Research with data from Bloomberg

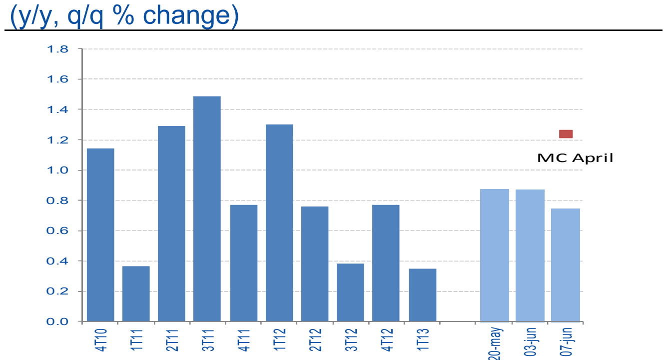
- Inflation will begin to fall in June and we expect a rebound in activity in the coming quarters following the rapid decline in 1Q13.

Chart 11
*Inflation Surprise Index (July 2002=100)



Source: Bloomberg and BBVA Research
*This measures the deviations in inflation in comparison to market-forecast figures, adjusting for inflation volatility. When it trends down, this implies a lower-than-expected inflationary surprise; when it trends up, this indicates a higher-than-expected inflationary surprise.

Chart 12
Observed GDP (y/y, q/q % change)



Source: BBVA Research

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