Mexico Weekly Flash

Next week…

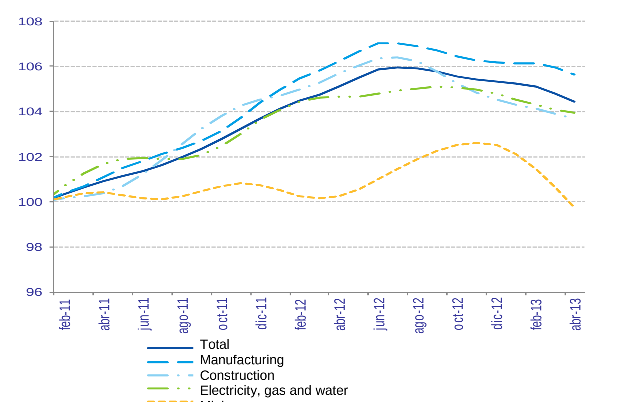
- **Banxico will reveal its monetary-policy decision, maintaining the rate without any changes, although there may possibly be a relaxed tone due to the weak economy**

This coming Friday, July 12, Banxico will announce its monetary-policy decision, which we expect to maintain the rate unchanged. However, with a scenario of slowing economic activity, core inflation below 3.0% and headline inflation expected to be under 4.0% from July (see the next page for more details on the inflation outlook), it will be important to see how the central bank weighs up the economic slowdown against the relaxation of monetary conditions caused by the recent losses in the exchange rate. Industrial output had an annual fall of 2.1% in April, consumer and producer confidence fell in June and the exchange rate has dropped by around 1.7% in the last month. These factors are key for evaluating monetary policy decisions in the second half of the year. In particular, in the future it will be important to monitor closely Banxico's vision with respect to economic activity in the second half of the year, which will be very important for assessing its monetary position in a context of a favorable trend in inflation.

- **The strength of the labor market in the U.S. increases expectations that the Fed will begin to reduce its rate of asset purchases at the end of this year**

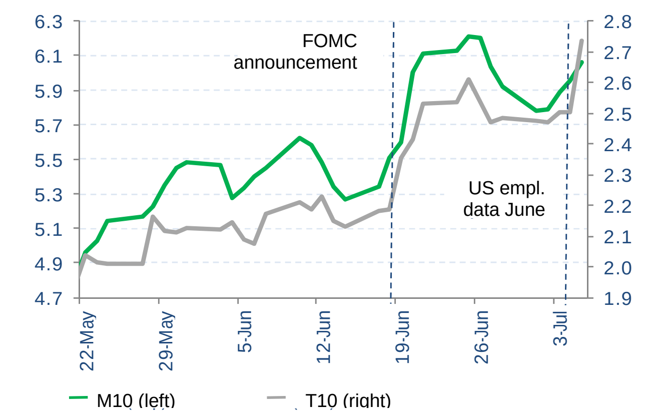
In the U.S. a total of 195,000 net jobs were created in June (around 35,000 more than expected). An additional 70,000 have been added due to upward revisions of the figures for the previous months, so the monthly rate in 2013 will be 202,000. The financial markets responded forcefully to this sign of strength in the U.S. labor market. The yield of the 10-year T-bond rose by 23 bps to 2.73%, its highest level since July 2011. The dollar strengthened against emerging currencies and also against the euro and pound sterling, partly as a result of the attempts by the ECB and Bank of England to distance themselves from the Fed this week: the ECB explicitly conditioning its response to the future trend in the monetary rate ("it will remain at its current level or lower for an extended period"); and the Bank of England suggesting it could adopt an explicit stance towards the monetary rate as soon as the next meeting. The interest rate of the 10-year Mexican bond increased by 14 bps over the week (11 bps on Friday) and the peso lost more than 1%, once more breaking through the level of 13.0 pesos per dollar.

Chart 1
Industrial Output: trend (January 2011 = 100)



Source: INEGI and BBVA Research

Chart 2
10-year interest rates (%)



Source: BBVA Research and Bloomberg

Calendar: Indicators

Inflation (July 9)

Forecast: -0.05% m/m; 4.1% y/y	Consensus: -0.02% m/m	Previous: -0.33% m/m; 4.7% y/y

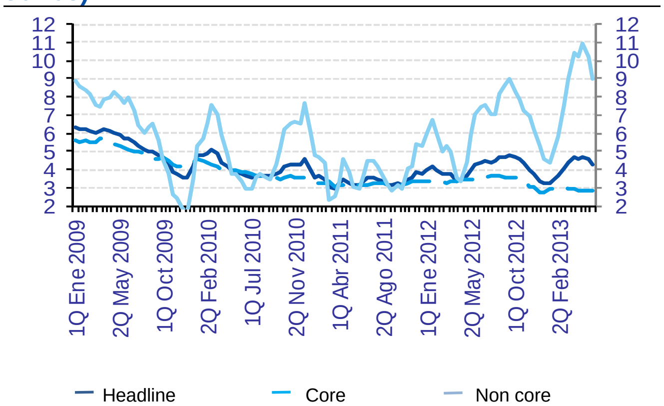
Next Tuesday we will know the inflation figures for June, which will confirm the strong downward trend in inflation. Inflation increased by 3.25% y/y in January to 4.65% y/y in May, pushed up by strong supply shocks to non-core inflation, such as: the freeze that harmed the green tomato crop; the yellow dragon plague in Colima, affecting the lemon price; the renewed outbreak of bird flue that has hit chicken prices, and to a lesser extent egg prices; the plummeting price of gasolines; and the major increases in public transport in a number of states. However, core inflation, which accounts for 75% of consumption for ordinary Mexicans, has since December averaged barely 2.9% y/y, due to the appreciation of the peso, lower grain prices and above all the prevailing slack in the Mexican economy maintaining unemployment rates much higher than pre-crisis levels, so domestic demand is still not a factor in upward pressure on prices. In June, inflation will have fallen, as the shocks affecting prices of agricultural products have eased significantly. There has also been a sufficient supply of various fruit and vegetables, and moderation in egg prices. In all, together with a favorable base effect compared with 2012, this has led to a significant fall in non-core inflation. Combined with the prevailing stability in core inflation, where the fall in inflation in goods has more than offset the slight upturn in services, this has led to a major moderation in inflation, which will fall from 4.65% in May to around 4.1% y/y in June. Thus, as expected by both the Central bank and BBVA Research, inflation is close to the target range for Banxico, and will remain within it for the rest of the year.

May industrial output (July 12)

Forecast: -0.2% m/m; -1.3% y/y	Consensus: N/A	Previous: -1.7% m/m; -2.1% y/y

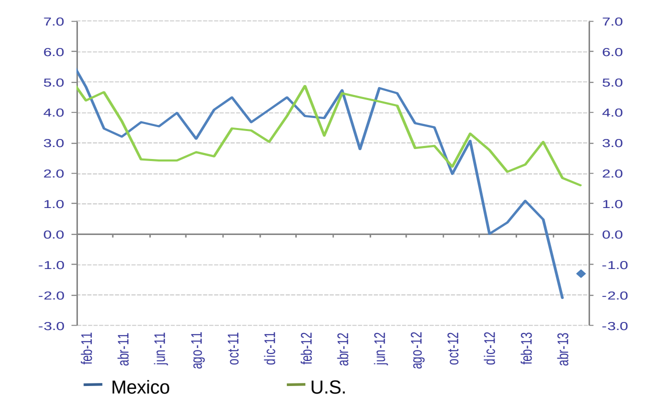
The figures for industrial output in May will be important. It should be recalled that industrial output fell back again in April far below expectations, due to the contraction in three of its four components, particularly in relevant manufactures and construction. The fall in industrial output in April is the second biggest since June 2009, at -1.7% m/m and -2.1% y/y. The manufacturing sector fell in April due to falls in 15 of its 21 branches. As was the case in April, we expect the branches most related to the external cycle will have had the biggest falls in May. U.S. manufacturing figures in May remained at their April level. Combined with weaknesses in other important markets, this leads us to consider that the fifth month of the year could still be negative.

Chart 3
Inflation breakdown (y/y % change, bi-weekly series)



Source: INEGI, Banxico, BBVA Research

Chart 4
Industrial output: Mexico and U.S. (y/y % change)

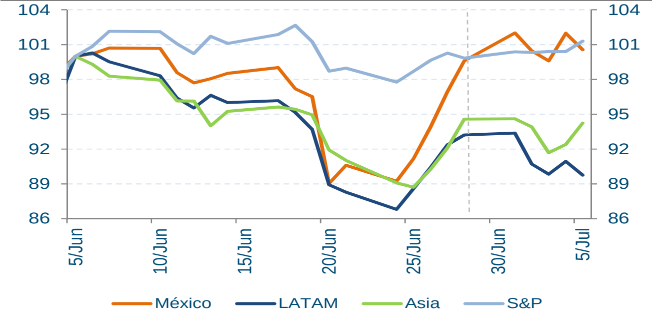


Source: BBVA Research and Bloomberg

Markets, activity and inflation

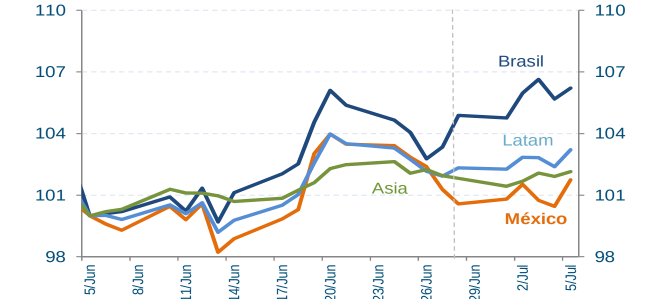
- Better than forecast employment figures in the U.S. increased the expectations that the Federal Reserve will begin to reduce the speed of asset purchases over the coming months. This in turn led to a depreciation of LATAM currencies and gains in the equity markets. The fall in metal prices was one of the reasons for the losses in the Mexico stock market at the end of the week, following the fall in the price of mining shares.

Chart 5
Stock markets: MSCI indices
(June 5, 2013 = 100)



Source: BBVA Research with data from Bloomberg

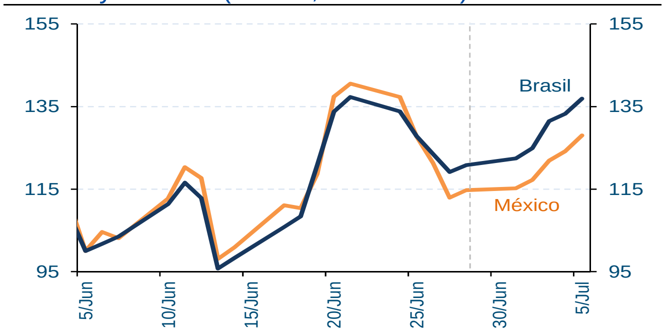
Chart 6
Foreign exchange: dollar exchange rates
(June 5, 2013 = 100)



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.

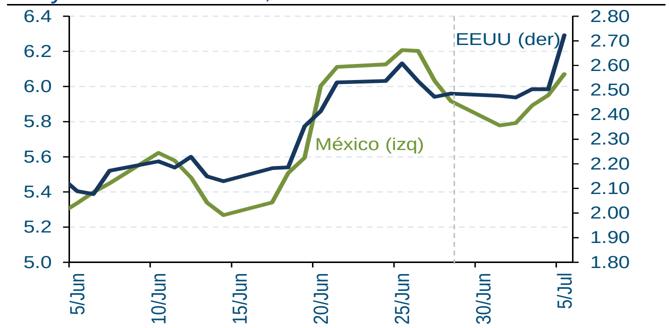
- Expectations that the Fed will reduce its rate of asset purchases has generated a rise in rates in the U.S. and Mexico of around 23 bps and 13 bps respectively in the closing session of the week. Risk aversion increased over the week.

Chart 7
Risk: 5-year CDS (June 5, 2013 = 100)



Source: BBVA Research with data from Bloomberg

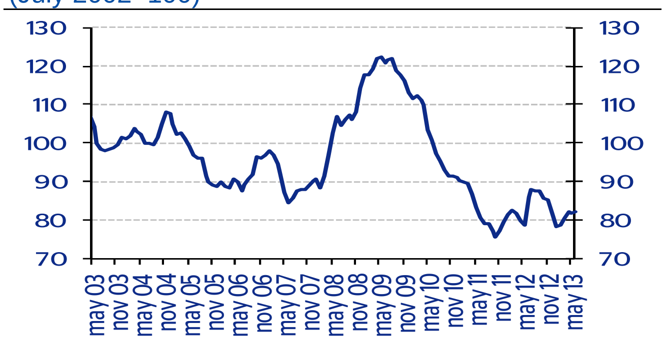
Chart 8
10-year interest rates, last month



Source: BBVA Research with data from Bloomberg

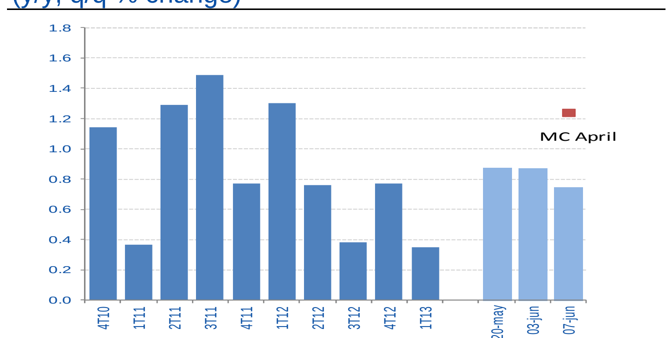
- Inflation will begin to fall in June and we expect a rebound in activity in the coming quarters following the rapid decline in 1Q13.

Chart 9
*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 10
Observed GDP
(y/y, q/q % change)



Source: BBVA Research

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