# Mexico Weekly Flash

## Next week…

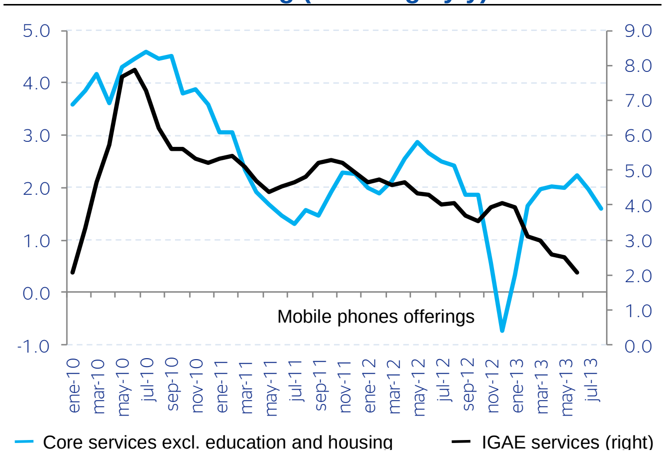
- ### Inflation data set to confirm no demand pressures

As we forecast, although surprising the market and analysts' consensus, Banxico cut its policy interest rate. The 25bp cut took the rate to 3.75%. The main factor underlying the decision was a weak economy (see Banxico Flash). Banxico stated economic growth in 2013 would be "considerably lower" to its 2-3% forecast for 2013 and that it would also reduce its 3.2%-4.2% forecast for 2014. The emphasis the Central Bank placed on the widening slack in the economy is particularly important, as is its anticipation of the subsequent impact on core inflation - remaining at all-time lows over the next 18 months. In light of the above, if the economic weakness and low inflation continue (3Q13 indicators do not point to improvement), the door will remain open for an additional cut in coming months. Along these lines, next Monday sees the release of inflation figures August. Inflation is forecast to see a monthly rise of 0.30% and come in at an annual rate of 3.47%. Prices of fruit and vegetables have continued to increase in the second half of August and a drop in some livestock products will not be enough to offset this rise. In turn, core inflation is expected to increase by 0.08% in the month, taking the year-on-year rate to a new record low of 2.36%. Seasonal factors have helped core inflation over the month (e.g. lower tourist services prices) but the key to downward pressure is a weak economy (see chart 1). Lastly, the details of the government's proposed fiscal reform are likely to be released on Sunday afternoon. This reform could have an impact on inflation.

- ### Financial variables continue to move in line with the US economic cycle

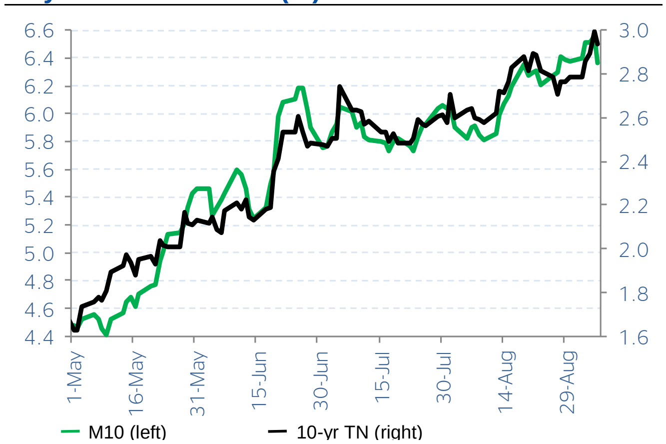
Despite the cut in the Banxico rate surprising the market, moves in Mexican financial variables (especially for the MXN) continue to respond to external factors, particularly the outlook for the decision at the Federal Reserve regarding the tapering rate for asset purchases. In this vein, after the surprise upswing in the US manufacturing ISM on Tuesday, the exchange rate rose to 13.39ppd although it ended the week at 13.17ppd (i.e. the peso strengthened 1.6%) after the job creation figures for August in the US saw a surprise downward move (+ 169,000). Mbond rates continue in high correlation with US Treasury bond rates.

Chart 1
**IGAE services and core inflation in services excl. education and housing (% change y/y)**




Source: BBVA Research and INEGI

Chart 2
**10-year interest rates (%)**



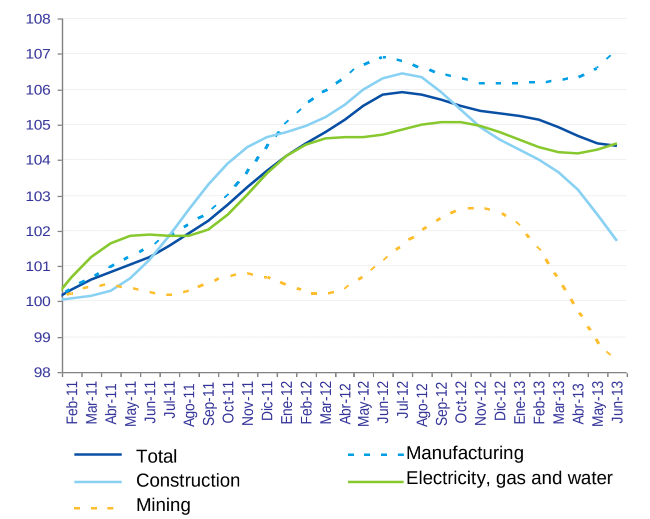

Source: BBVA Research, Bloomberg.

## **Industrial Output in July** (September 11)

| Forecast: -0.7% y/y, 1.1% m/m, CSV | Consensus: N/A | Previous: -1.5% y/y, -0.03% m/m, CSV |
|---|---|---|

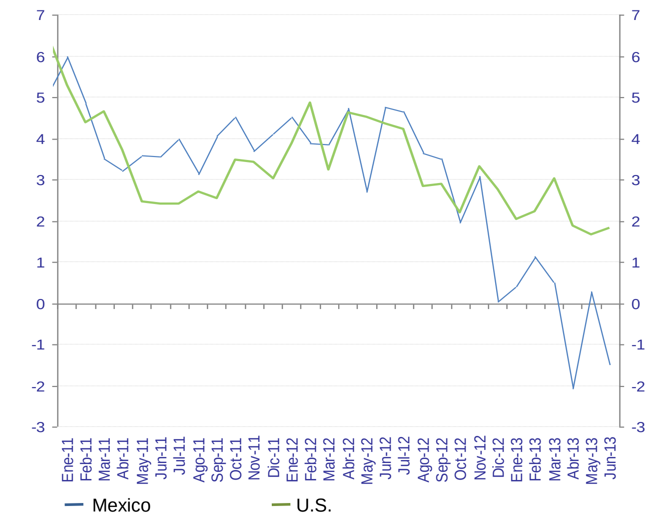
Industrial output performance in July will be released this week. At this time, this indicator is more important since Mexican industrial output in June fell to an annual rate (y/y) of -1.5% (corrected for seasonal variation - CSV). The decline in Mexican industrial output was due to the contraction in three of its four components, construction (-5.6% y/y, CSV), mining (-3.0% y/y, CSV), electricity, gas and water (-0.2% y/y, CSV). One of these components is highly likely to remain in decline, especially if we take into account that Gross Fixed Investment (spending on machinery and equipment made domestically and imported, as well as from construction) dropped 1.13% in June compared to the previous month (CSV) and due to industrial output in the US coming in sluggish with monthly growth of 0.2% in June and 0.0% in July, although it is forecast to improve in coming months. In this way, the drop in the Mexican industrial indicator is forecast to continue, albeit at a lower rate, i.e. going from -1.5% in June to -0.7% in July y/y CSV.

Chart 3
**Industrial Output: trend (January 2011 = 100)**




Source: BBVA Research with INEGI data.

Chart 4
**Industrial output: Mexico and US (% change y/y, CSV)**

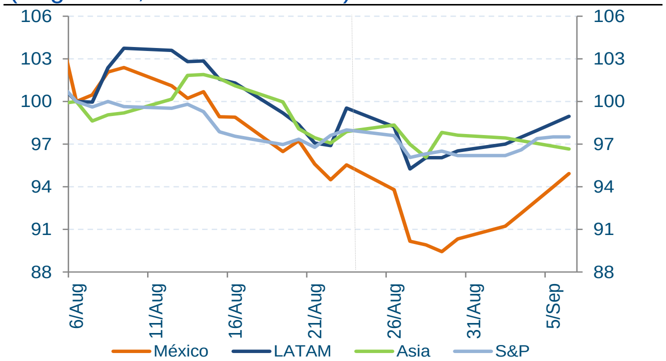



Source: BBVA Research with Bloomberg data.

# Markets, activity and inflation

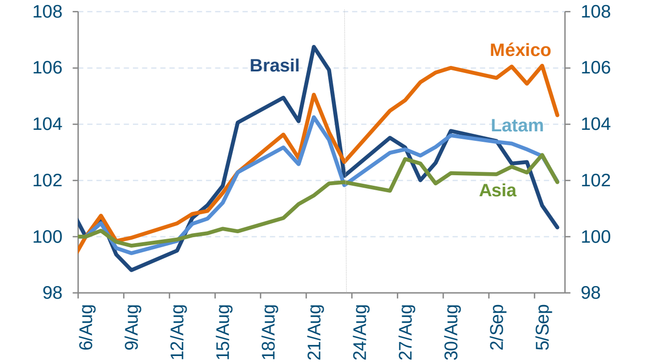
- Moves in the peso continued to be set by external factors, mainly linked to the perceived strength of the US economic cycle. In this vein, it weakened in line with other emerging market currencies on Tuesday after the surprise upswing in the manufacturing ISM and strengthened on Friday after the job creation figures for August in the US saw a surprise downward move.

Chart 6
**Stock markets: MSCI indices (August 06, 2013 index=100)**




Source: BBVA Research with data from Bloomberg

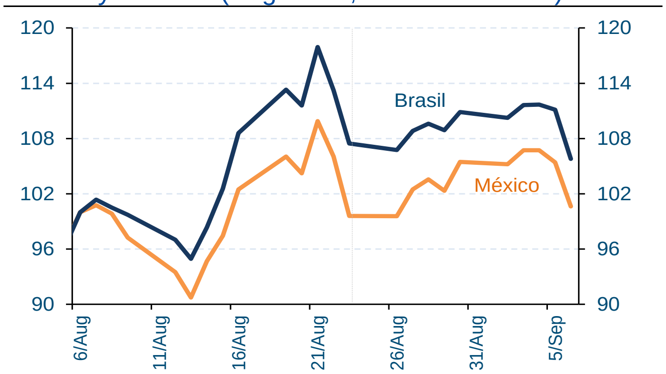
Chart 7
**Foreign exchange: dollar exchange rates (August 06, 2013 index=100)**




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.

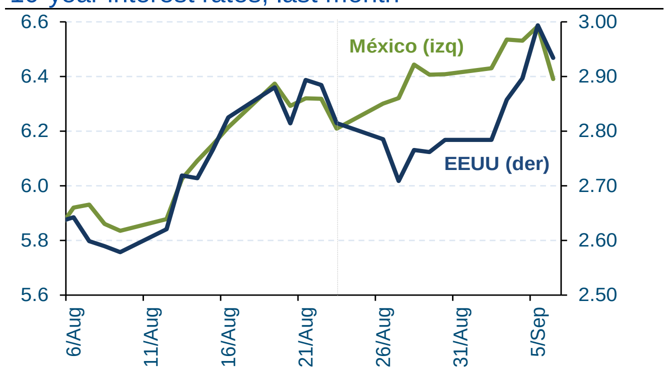
- Mexican interest rates again fell into synch with US rates, confirming they are mainly set by the US economic cycle. The CDS remained in a narrow range.

Chart 8
**Risk: 5 year CDS (August 06, 2013 index=100)**




Source: BBVA Research with data from Bloomberg

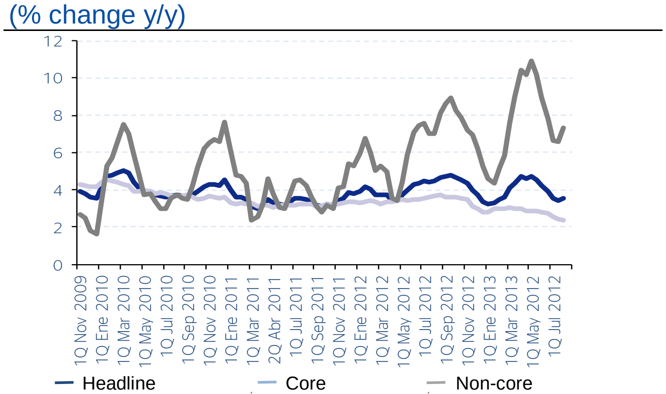
Chart 9
**10-year interest rates, last month**




Source: BBVA Research with data from Bloomberg

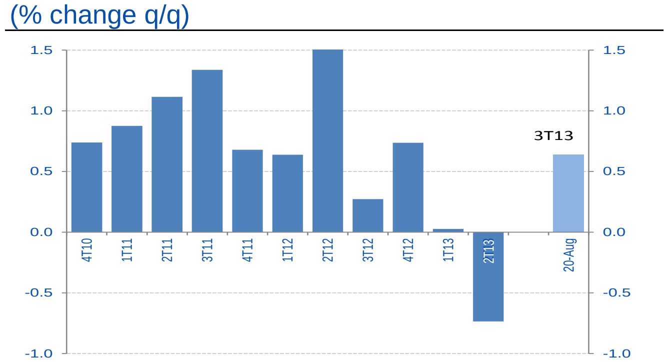
- The slack economic output points to core inflation remaining near current levels in coming months. Economic growth is expected to see a bounce this quarter, although recent data continues to show weakness.

Chart 10
**Inflation Breakdown (% change y/y)**




Source: INEGI and BBVA Research

Chart 11
**Observed and estimated GDP 3Q13 (% change q/q)**




Source: BBVA Research

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