Mexico Weekly Flash

Next week…

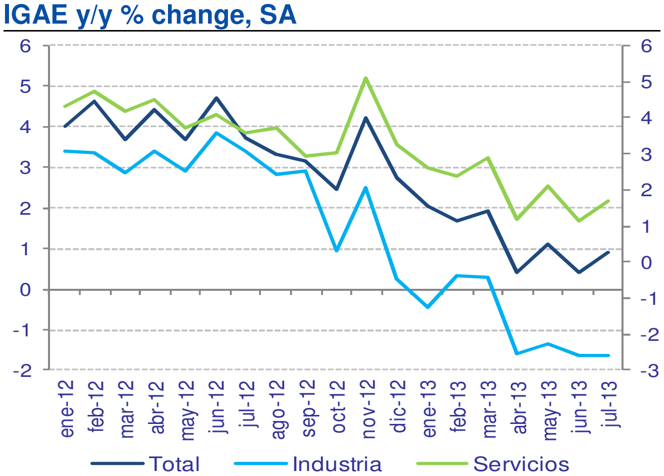
- **25 bp cut in the monetary policy rate**

  Banxico will release its monetary policy decision next Friday. We expect the central bank to reduce the one-day interbank lending rate target by 0.25% based on the following arguments. Firstly, GDP is far off its potential rate and the economic recovery in the third quarter has been below expectations. Industrial output figures for August show that both the mining and construction components maintain their negative trend, even though manufacturing shows signs of moderate recovery. Secondly, given the slack in the economy, no demand pressures on prices are forecast. We estimate that inflation will end the year at around 3.6%. Thirdly, the financial markets have behaved in an orderly fashion. In the minutes of the latest monetary policy meeting, most members of the governing board considered that the markets have incorporated to a great extent the effects of a slowdown in the purchases of assets by the FED, and that the exchange rate movements have taken place in an orderly manner. Following the expected cut, an additional cut would seem unlikely given the scenario of stronger growth for next year and the potential increase in inflation in response to the proposed fiscal measures.

- **The fiscal agreement in the U.S. contributes to positive market performance**

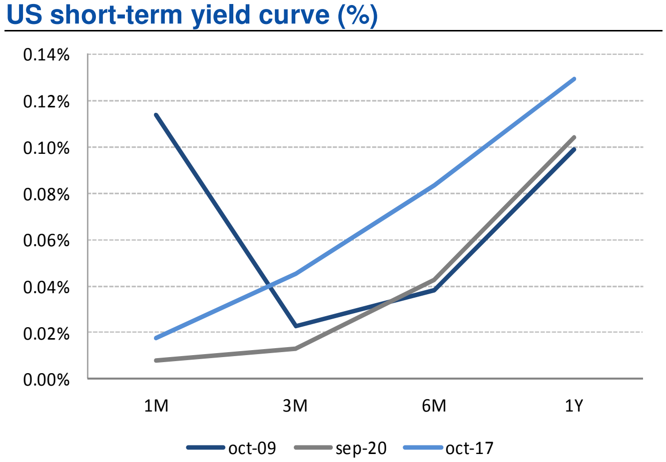
  Last Wednesday, the U.S. Congress reached an agreement to increase the debt ceiling and end the government shutdown. The agreement extends the government's power to borrow until February 7 and grants funding to keep the government in operation until January 15, 2014. Unlike other episodes of fiscal paralysis in the U.S., the financial markets' reaction was more moderate, influenced by the expectations of a last-minute agreement, as had happened on previous occasions. Once the agreement was announced, the 1-month bond yield rate in the U.S. fell by 22 bp, while gains were posted on the stock markets. The peso strengthened by 1.18%, the strongest appreciation among emerging currencies.

Chart 1
IGAE y/y % change, SA



Source: BBVA Research with INEGI figures. SA=Seasonally adjusted.

Chart 2
US short-term yield curve (%)



Source: BBVA Research and Bloomberg.

Calendar: Indicators

Retail stores in August (October 21)

Forecast: -0.2% y/y, -0.2% m/m, SA	Consensus: N/A	Previous: 0.9% y/y, 0.6% m/m, SA

Surprisingly, retail sales (seasonally-adjusted figures) grew 0.9% y/y in July 2013, mainly as a result of increases in the following subsectors: motor vehicles, spare parts, fuels and lubricants, textiles, clothing accessories and footwear, and healthcare products. The ANTAD sales indicator has performed weakly in August and September (-3.5% and -4.6%, respectively, SA) and producer confidence has only improved marginally. As a result, retail sales are expected to decline 0.2% y/y in August.

IGAE in August (October 25)

Forecast: 1.2% y/y, SA	Consensus: N/A	Previous: 0.9% y/y, SA

On Friday, October 25, INEGI will release the IGAE for August. It will provide more details on the performance of the Mexican economy at the close of the third quarter. In July, this indicator grew moderately in annual terms (0.92%, SA) as a result of the upturn in services (2.2% y/y, SA) and the agriculture sector (1.1% y/y, SA), while the manufacturing sector declined 1.6% y/y, SA. Due to the improvement in the Mexican industrial activity indicator (0.49% m/m, SA) and a slight upturn in formal employment in the services sector (0.2% m/m, SA), both for August, the IGAE is expected to reveal annual growth of 1.2% (seasonally-adjusted figures).

Inflation for the first two weeks in October (October 24)

Forecast: 0.51% (3.43% y/y)	Consensus: 0.35%	Previous: 0.01% (3.39% y/y)

The inflation figure for the first two weeks in October will be released on Thursday, and will continue to show stability in year-on-year inflation and no demand pressures. In bimonthly terms, we expect a 0.51% upswing in headline inflation and 0.13% in core inflation. The trend seen over the last two months in terms of core inflation is expected to continue, with the stronger increases in the goods sub-index being offset by the favorable performance of the services sub-index as a result of ongoing economic weakness. As for non-core inflation, we expect a significant increase in agricultural prices (around 2% bimonthly), considering that there may be a delayed effect between wholesale prices and final prices which is not reflected in the second half of September. Consequently, annual inflation will remain at 3.4%, while core inflation will remain at 2.5%. The absence of demand pressures due to the slack in the economy and economic weakness point to an additional cut of 25 basis points in the policy rate at Banxico's meeting next Friday.

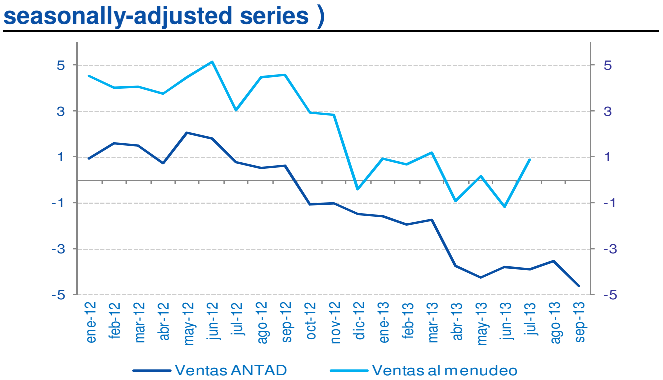
September trade balance (October 25)

Forecast: -374 md	Consensus: md	Previous: -234.2 md

The trade balance figures for September will be released next Friday. We expect to see some growth in exports (2.2% y/y) due to the recent upswing in manufacturing output in the U.S. (2.7% y/y in August). Imports are also expected to pick up speed in September, after the decline posted in August (in all components). Thus, a negative balance of around 374 million dollars can be expected in the trade balance for September.

Chart 3

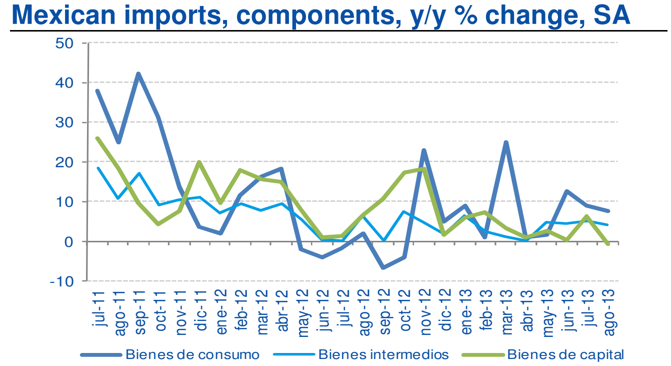
Retail stores and ANTAD sales (y/y % change, seasonally-adjusted series)



Source: BBVA Research with ANTAD and INEGI figures.

Chart 4

Mexican imports, components, y/y % change, SA

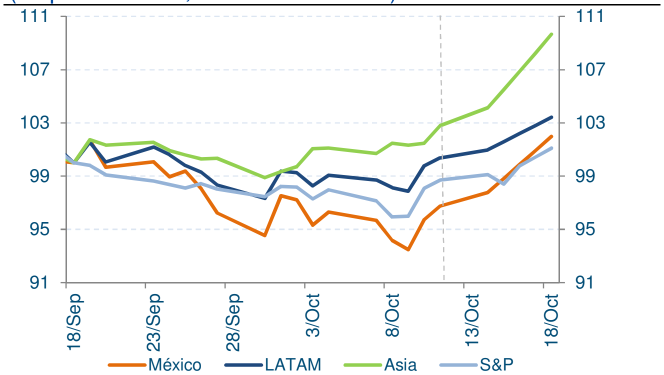


Source: BBVA Research, INEGI. SA=Seasonally adjusted.

Markets, activity and inflation

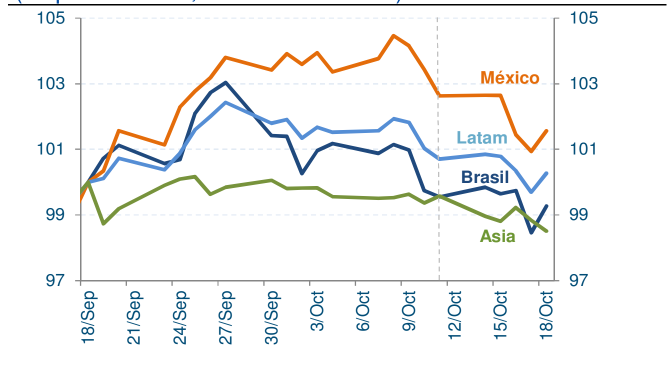
- Stock market and currency gains following the announcement of the fiscal agreement in the U.S. After the agreement, the peso posted the greater appreciation among emerging currencies.

Chart 5
Stock markets: MSCI indices
(September 18, 2013 index=100)



Source: BBVA Research with data from Bloomberg

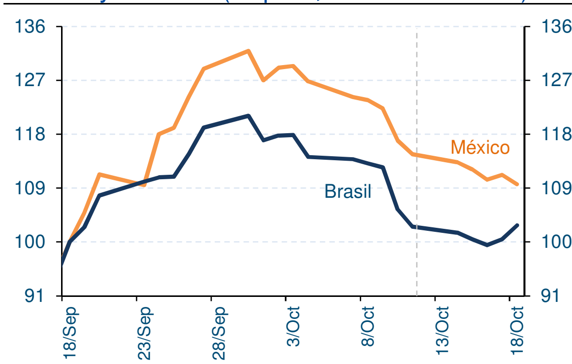
Chart 6
Foreign exchange: dollar exchange rates
(September 18, 2013 index=100)



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.

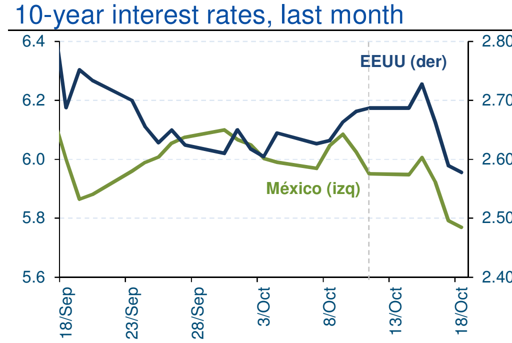
- Fall in global risk aversion once the risk of default in the U.S. was dispelled. Long-term rates in Mexico have fallen in line with the rate cuts in the U.S.

Chart 7
Risk: 5-year CDS (Sep 18, 2013 index=100)



Source: BBVA Research with data from Bloomberg

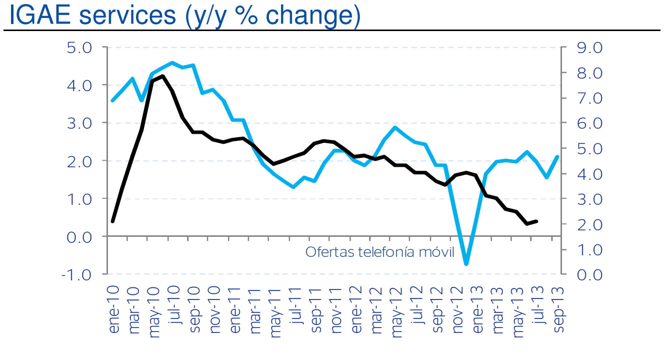
Chart 8
10-year interest rates, last month



Source: BBVA Research with data from Bloomberg

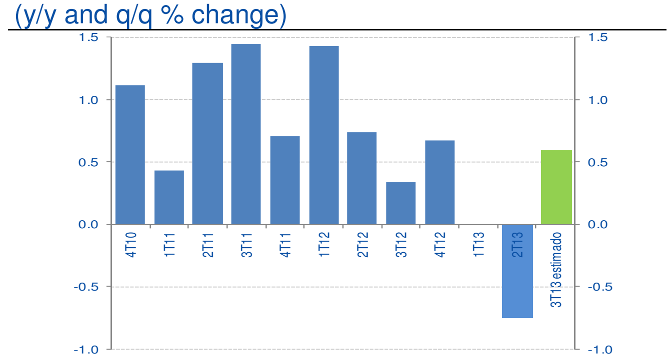
- Despite the economic effects of the floods, inflation remained stable. Industrial output for August confirmed a slight upswing in the third quarter.

Chart 9
Core inflation in services excl. education, housing and IGAE services (y/y % change)



Source: BBVA Research, INEGI

Chart 10
Observed and estimated GDP 3Q13
(y/y and q/q % change)



Source: BBVA Research

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