

Monthly, September 2009

The arguments of the month

- *The return of the global risk appetite has benefited the financial markets of emerging economies. However, since August the rally has slowed down.*
- *Domestic financial variables continue to record a negative differentiation compared to their emerging counterparts, mainly in Latin America. Greater uncertainty regarding the sustainability of public balances in a climate of lower global risk aversion levels should offset this divergence, with a relative appreciation in the exchange rate and a fall in long-term rates.*
- **To monitor!: the slope of the rates curve.** *The gap between long-term and short-term rates in Mexico is showing strong resistance to the downtrend related to low liquidity levels. The certainty that the measures to be taken in the 2010 Budget will help to raise the low tax collection level and the efficiency of public spending in the long-term will allow the related risk premium on the domestic curve to be lowered if the budget is approved in line with what has been announced.*

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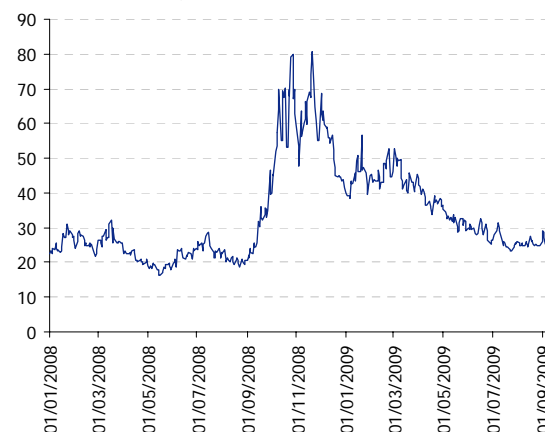
From March this year onwards, the return of the global risk appetite has benefited the financial markets of emerging economies. However, since August the rally has slowed down.

This slowing down could mean that the previous strong rally (from March to July) was driven by excessive optimism about the strength of the global economic recovery that is underway.

Risk aversion reaches all-time highs (4Q08), and then stays at high levels (1Q09). The financial crisis, which took on global proportions following the collapse of the Lehman Brothers mid-September 2008, reached rock bottom in 4Q08, when it rose to record high volatility and risk aversion levels. Although at the start of this year (January-February) volatility dropped compared to the overreaction experienced at the end of 2008, it still remained at sky high levels (chart 1). Following the heavy falls in 4Q08, the financial variables on emerging markets did not record significant upturns during 1Q09 either (chart 2).

Return of the risk appetite and rally on emerging markets (Apr-Jul09). April saw a consolidation of the return of the risk appetite on financial markets that started in mid-March, when the financial stabilization plans in the US included bank capitalization exercises. Economic indicators stopped recording an increased unraveling and even showed signs of green-shoots. Financial markets no longer quoted a global financial crisis and even started to speak about the end of the global recession and an imminent recovery in the cycle. During this period, volatility dropped and on average returned to pre-crisis levels. In this context, greater risk financial instruments benefited.

However, during August-September the rally came to an end, although without going back to higher risk levels in view of the increased uncertainty regarding the strength of the recovery. The strong rally seems to have halted over the last six weeks, partly due to more skepticism about the robustness of world demand. This is all against a background of job losses and a situation in which households will increase their savings (i.e. they will curb their spending) to revive their balance sheets which are still suffering from the excesses of the previous expansive cycle.

Figure 1. VIX (Volatility Index)

Fuente: Bloomberg

Figure 2. MSCI Emerging Markets (Index)

Fuente: Bloomberg

The negative differentiation in domestic financial variables will tend to be offset

The development of Mexican financial variables has been influenced by the global situation. However, they continue to record a negative differentiation compared to their emerging counterparts, mainly in Latin America.

The level of discrimination towards financial assets measured by the CDS suggests that the cost of buying protection against the risk of non-payment has systematically remained higher than other emerging markets, including those with a lower quality sovereign credit rating. As regards EMBI+ Mexico sovereign debt rating trends, they have been a lot more significant and volatile.

The value of the Mexican peso has also been affected by negative discrimination. This trend is largely related to the uncertainty regarding public financing capacity, in a climate of heavy economic decline and a fall in oil prices. The Budget package for 2010 plans to cover the advance deficit with a combination of spending cuts, revenue increases – tax, controlled prices and non-recurrent earnings increases – and a temporary additional increase in debt. Should a set of measures that respond to the challenge of increasing non-oil tax revenue in the long-term and improving the efficiency of Government spending finally be approved, we could see a considerable offsetting in the risk premium of domestic financial variables. In fact, other economic reforms to be discussed in Congress to make the economy more flexible and boost growth should help to reduce this premium. In this situation, we would see an appreciation in the Mexican peso above its equilibrium level (which we estimate to be around 13.0-12.5 ppp).

Over the coming months, Banxico's monetary policy stance is not likely to change: we expect a prolonged pause. A downward trend in long-term rates is foreseeable.

The M10 interest rate fluctuated around 8.0% in spite of the greater appeal of more risky financial assets and the heavy monetary easing cycle.

The monetary pause will remain for a long period. Until a few months ago, Banxico's balance of economic risks had moved steadily towards lower growth risks. Although the beginning of the end of recession and the uncertainty as to the size of the (temporary) inflationary fiscal shock are starting to balance this assessment out, we still believe that there is a slant towards lower growth risks, leading to a prolonged monetary pause.

As regards long-term interest rates, they have remained high due to several factors. Apart from a structural spread component (term premium), other inflationary risk components are currently also carrying weight (due to the foreseeable increases in public prices and the uncertainty regarding the impact of forecast tax changes on inflation), as well as another component that is related to the current stage of the economic cycle, i.e. due to market expectations of increases in the bank lending rate in 2010. However, there are another two factors that explain the stubborn downtrend of long-term interest rates to a greater extent: a) a liquidity factor, and b) another factor related to Mexico's negative differentiation due to tax matters. As regards the first factor, on the market there is still an acute preference for liquidity and for short terms, as well as a lack of interest from foreigners on the curve. Regarding the second factor, concerns about the sustainability of public finances are also influencing the high levels of long-term yield.

A clearing of the fiscal uncertainty would help the peso and help to lower long-term interest rates and moderate the slope of the curve.

Figure 4. Exchange Rate (vs USD)
(Index Sept01-08=100)

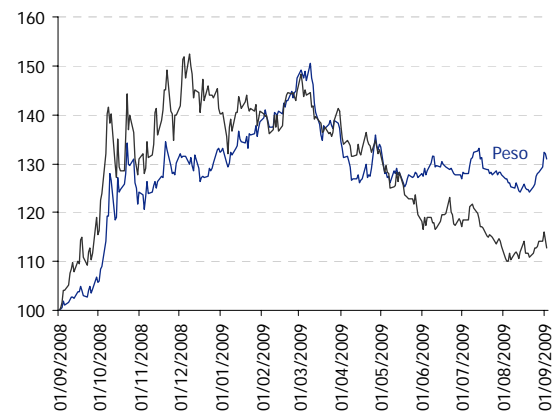
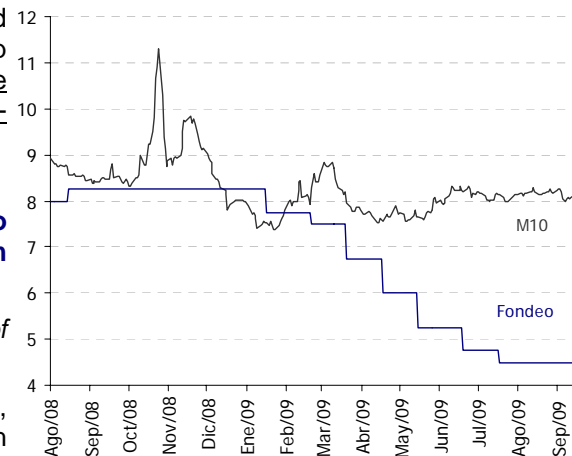
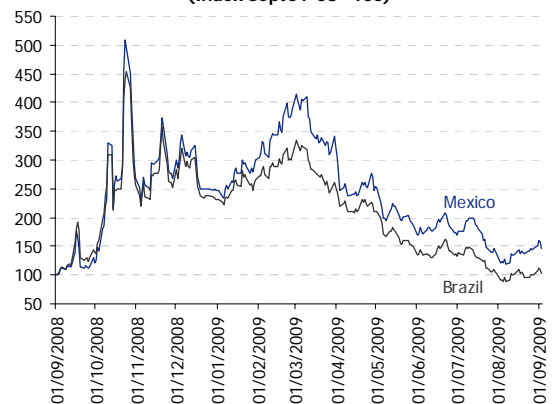


Figure 5. M10 & Fondeo (%)



Fuente: ERD BBVA Bancomer, Bloomberg

Figure 3. CDS 5 years
(Index Sept01-08=100)



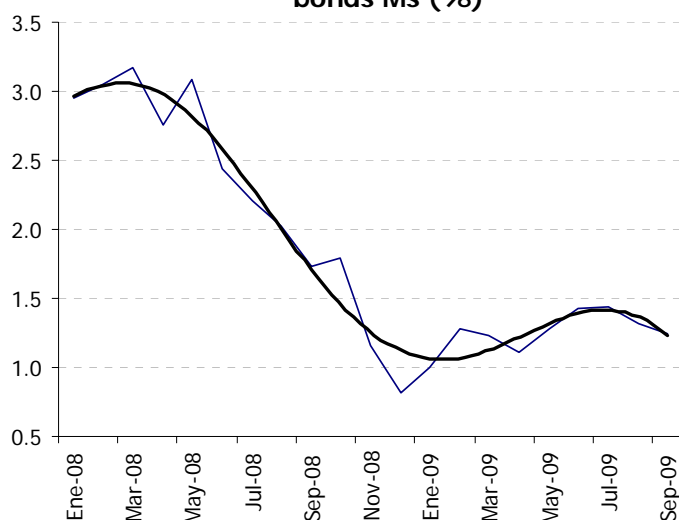
Fuente: ERD BBVA Bancomer, Bloomberg

To monitor!

Liquidity on the bond market continues to flirt around ranges below 1.5% on average, which partly explains the stubbornness of the long section of the curve to come down. The factors underlying these levels are: a) risk aversion related to uncertainty regarding fiscal sustainability; 2) lower rate of foreign capital flows; 3) funds, mainly pension funds, at their VaR limits.

We think that although a strong risk appetite situation is not expected, the global economic cycle will limit downtrends. Therefore, foreign flows into the bond market should begin to be offset during the last quarter of 2009. In addition, in a climate of greater certainty regarding the financing and sustainability of public finances, the likelihood of facing a change in the sovereign debt rating would be reduced significantly and, with it, the related risk premium on the domestic curve. We forecast that the negative differentiation of domestic financial variables versus other emerging economies will be reversed over the coming months. To sum up, we expect a gradual offsetting of liquidity levels on the bond market and a downtrend in the curve slope. Because the SHCP has stressed that if the tax collection reform is not approved there could be a situation of fiscal unsustainability, the approval of a highly watered-down reform could be frowned upon by financial markets. Important dates on the legislative Budget approval calendar are October 15 and November 20, the deadlines to approve the income and expenditure budgets respectively.

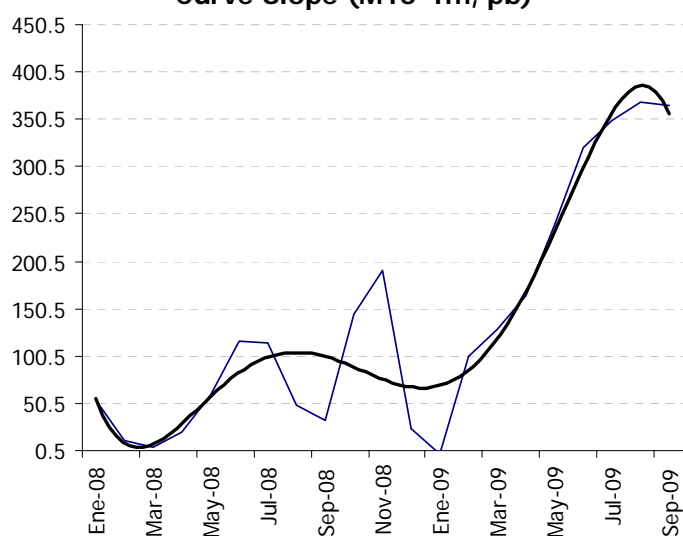
Liquidity Indicator of long-term yield bonds Ms (%)



Fuente: Banxico & ERD BBVA Bancomer

Indicador *Turn-over*: *Títulos operados/Títulos en circulación*

Curve Slope (M10-1m, pb)



Fuente: Banxico & ERD BBVA Bancomer