

Mexico

Weekly Watch

August 06, 2010

The week to come

Economic Analysis

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The July inflation figures will be the first to show an increase this year; this will continue throughout the rest of the year as a result of cyclical factors and the policy of increases in administered prices. At year-end, inflation will be 5.2%

After three consecutive months of positive surprises, we expect the monthly inflation rate for July to increase by 0.28%, slightly higher than the latest analyst consensus (0.24%). Over recent months, one of the main factors affecting inflation has been the favorable performance of agricultural product prices. However, we expect this trend to be reversed by cyclical facts from July. If this occurs, we consider that a positive surprise will not have any effect in the form of an additional reduction in the bank lending rate.

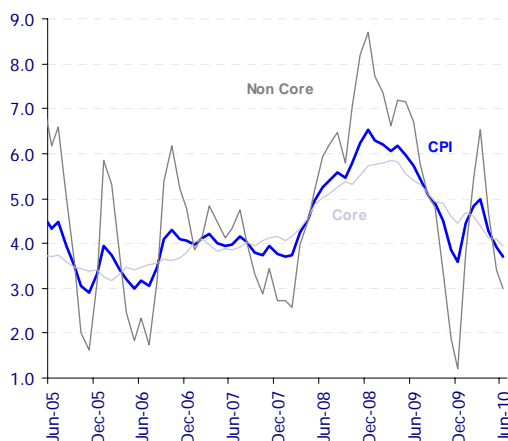
The most recent indicators from the USA confirm a slowdown in growth rates from the end of Q2. Figures for July inflation and retail sales may alleviate concerns a little this week.

In the USA, where markets are ever less sensitive to surprises in US economic indicators, figures for July inflation and retail sales will be released this week. The figures for core inflation in July will be of particular interest; we expect 0.2% mom, compared to a consensus view of 0.1%. We consider that the downward trend in annual core inflation may have bottomed out. A downside surprise would reinforce fears of the risk of deflation. Retail sales may grow by 0.5% after having fallen in the last two months. However, after this rebound, the dynamism will slow as a result of the situation in, and outlook for, the labor market. A negative surprise would increase growing concerns about the strength of private demand.

The fixed income markets are pricing-in expectations of a longer monetary pause. Cyclical fears have a negative effect on exchange rate parity

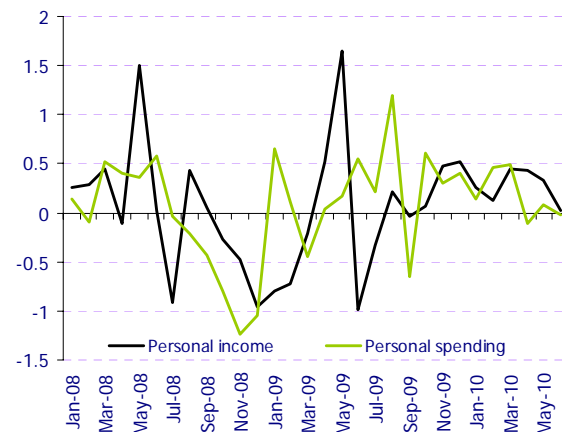
The yield curve is discounting a longer monetary pause, which may be confirmed as a result of the July inflation figures. The risk aversion generated by the cyclical situation in the USA resulted in a 0.68% weekly depreciation in the MXN, which worsened at the end of the week after the release of US payroll data.

Chart 1
Inflation breakdown
(% yoy change, monthly series)



Source: BBVA Research with Banxico data

Chart 2
Personal Income and Consumption in the U.S.
(% mom change, a.e. data)



Source: BBVA Research with Bloomberg data

Economic Analysis

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Calendar: Indicators

Monthly inflation, July (August 9, 9:00 AM)

Forecast: 0.28% mom (3.70% yoy) Consensus: 0.24% mom (yoy N/A) Latest data: (-)0.03% mom (3.69% yoy)

We expect an inflation rate of 0.28% for July, the first increase of 2H10, with an annual rate of 3.7%. After three consecutive months of positive surprises, we expect the monthly inflation trend to reverse, and for there to be a series of subsequent increases as a result of cyclical factors which will increase fruit and vegetable prices, the policy of increasing administered prices and the base effect of services. As a result, we forecast year-end inflation of 5.2%, and 3.68% in 2011.

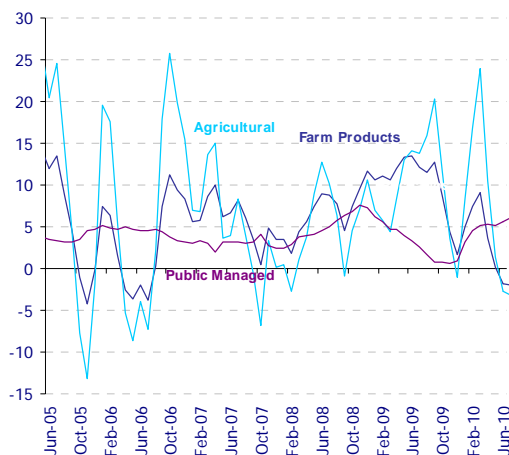
Industrial activity, June (August 11, 9:00 AM)

Forecast: 0.4% mom (9.6% yoy) Consensus: -0.8% mom (8.3% yoy) Latest data: 0.5% mom (8.6% yoy)

Despite the possibility that the June industrial activity indicator will show a one percentage point rebound in annual terms compared to May, in monthly terms there will be a slight moderation which will confirm the slowing trend seen over recent months. The figures will show that the boost is coming from the manufacturing sector and is export-related. However, the July manufacturing activity index (IMEF) was down, falling to 53.5 compared to 53.6 in June. In addition, there was an increase in stocks, which is consistent with the USA ISM manufacturing index for the same month, and this points to a slowdown in the rate of expansion in the coming months. This leading indicator of industrial output suggests that the boost from external demand will reduce over the second half, which means that a clearer recovery in domestic demand will have greater importance.

Chart 3

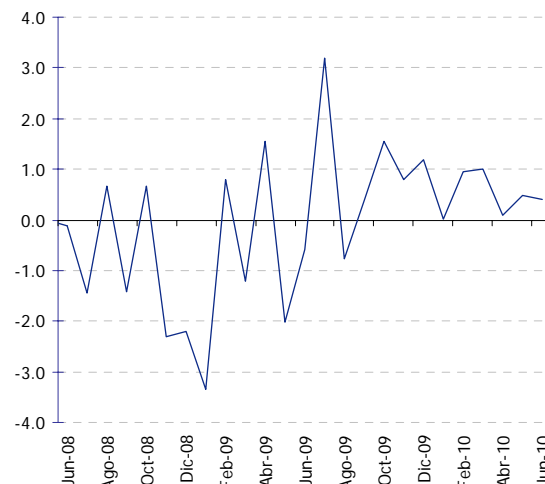
Non-core inflation and components (% annual change, monthly series)



Source: BBVA Research with Banxico data

Chart 4

Industrial output (% monthly change)



Source: BBVA Research and INEGI

Market analysis

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Markets

Exchange rate depreciation sharpened at the end of the week as a result of increased cyclical risk deriving from US payroll data

Over the last week, the still latent uncertainties about the American cycle continued to cause revaluations in the main risk-free assets (e.g. the Japanese yen broke through the 2009 minimum levels and the 10-year U.S. Treasury bond was at the support zone of 2.90%), and this movement was accentuated following Friday's figures. Despite continuing favorable corporate reports and the positive bias in European risk premiums (particularly following the results of debt auctions in Spain), the risk aversion results from a 0.68% weekly depreciation in the MXN, which was accentuated at the end of the week following the release of US payroll data.

It is worth noting that while there were divergent movements in global markets (for example, commodity prices were up over the week; varying performance by the currencies of emerging economies; and Latin American stock indices finished the week up), the currency displayed greater correlation with fixed income instruments, both locally (particularly those with shorter maturities) and externally (this being the only one in the zone which reacted to the movement in 10 Year Treasury Bills). In summary, the currency did not break out of the upper end of the 200 day moving average, as a result of which we do not expect any reversal of the recent trend; we expect movements within the range 12.55-12.72 over the short term.

Fixed income markets expect a more prolonged monetary pause as a result of recent inflation and cyclical fears.

As a result of recent inflation performance and risks loaded towards lower growth, the market has delayed its expectations of increases in interest rates. At the start of the year, the implicit yield on the TIIE Interbank Equilibrium Interest Rate curve was discounting a 25bp increase in October 2010, whilst the market is now expecting this not to occur until March 2011. This change is consistent with the implicit rate on the CETES curve, which is also discounting a scenario with a longer monetary pause. This feeling may be consolidated following Monday's inflation figures. We hold our forecast that Banxico will increase its rates in April 2011 (vs. May 2011 in the consensus view), with a series of 25bp increases to 6% in September 2011.

Risk premiums returning to normal: corporate issues in Latin America have benefited from improvements in the European environment.

European sovereign and bank risk premiums have begun to fall after the events of previous weeks (due to the results of the stress tests). Although global risk premiums have not yet returned to levels prior to the recent period of volatility, they are on the way back to normal (e.g. CDS on European sovereign debt fell in the last month by 20.2%, 111 bps as on August 11, 2010).

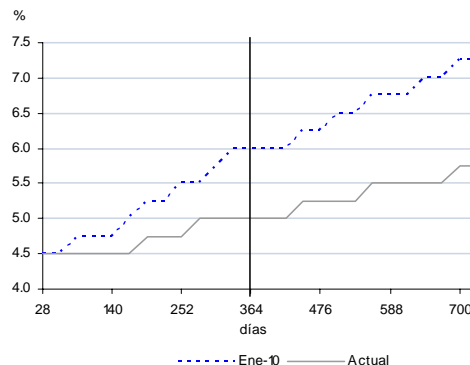
Although Mexican corporate surcharges remained relatively immune to the pressures in Europe, they have also benefited from the slight reduction in risk premiums and the increase in issues, mainly in the Brazilian banking sector. The Corporate Emerging Market Bond Index (CEMBI) stood at 313 bps over the U.S. Treasury bond curve as on August 5 (monthly fall of 37 bps).

Chart 5
Mexico: MXN vs. 2 year bond (ppd and %)



Source: BBVA Research with Bloomberg data

Chart 6
Mexico: Implicit funding rate on the TIIE curve



Source: BBVA Research with Bloomberg data

Technical Analysis

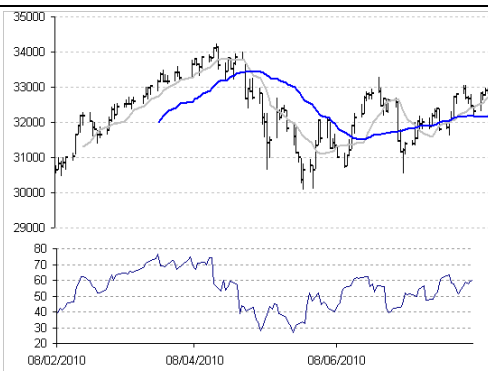
Market analysis Equity

Technical Analysis

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CPI

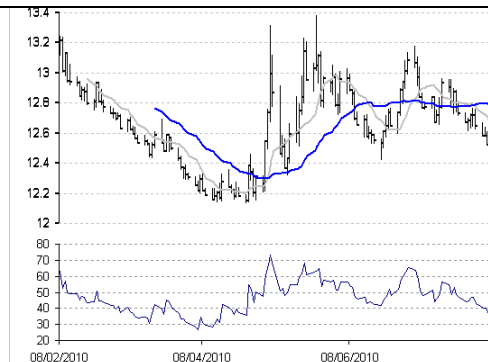


Source: BBVA Bancomer, Bloomberg

CPI: Rebound during the week from the 200 day moving average; however, this change is not strong enough to break out upwards through the 33,000pts resistance level. The outlook for a rebound will continue whilst it continues to operate above the 10 day moving average (32,733pts). A downward break through this level would start a return to the zone of the 30 day moving average of 32,200pts.

Previous recommendation: Reaching the rebound level delimited by the 200 day moving average, the previous minimum and the lower part of the current short-term channel.

MXN

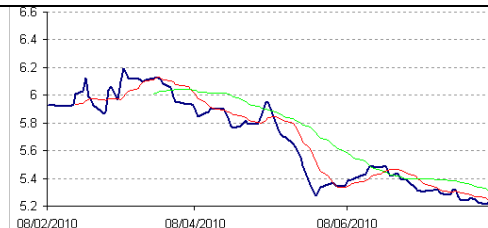


Source: BBVA Bancomer, Bloomberg

MXN: Encountering a floor at levels of P\$12.50, from which a technical rebound is starting. The resistance level is at P\$12.80; however, the oscillations suggest that this level may be broken to reach new levels of P\$13.00/13.20.

Previous recommendation: Breaking P\$12.80 opening the possibility of return to levels of P\$12.65 and P\$12.50.

3-YEAR M BOND

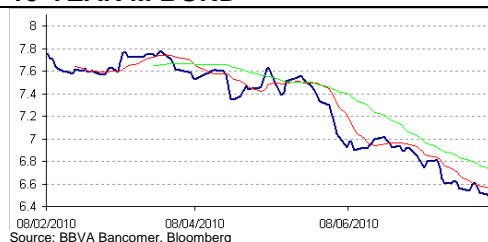


Source: BBVA Bancomer, Bloomberg

3-YEAR M BOND: (yield): A slight rebound at the end of the week to a level slightly above the 10 day moving average (5.2381). The 30 day average (5.3021) would have to be broken to consider a change of the short-term trend to have taken place.

Previous Recommendation: Any upturn would be limited to the 5.37 zone.

10-YEAR M BOND



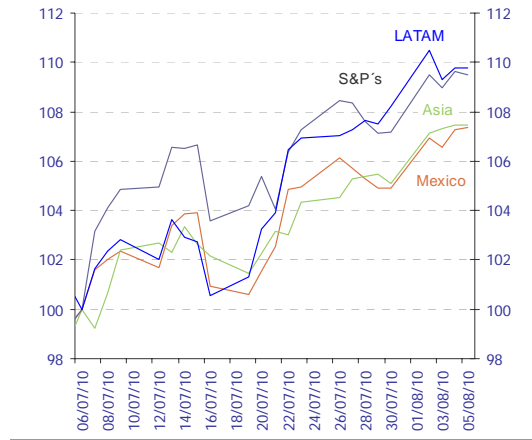
Source: BBVA Bancomer, Bloomberg
Source: BBVA Research with Bloomberg data

10-YEAR M BOND (yield): A new low for the year during the week, with the continuing outlook of a limited recovery to the 10 day (6.5414) and 30 day (6.696) moving averages.

Previous recommendation: Possible rebound with resistance at 6.68 and 6.83.

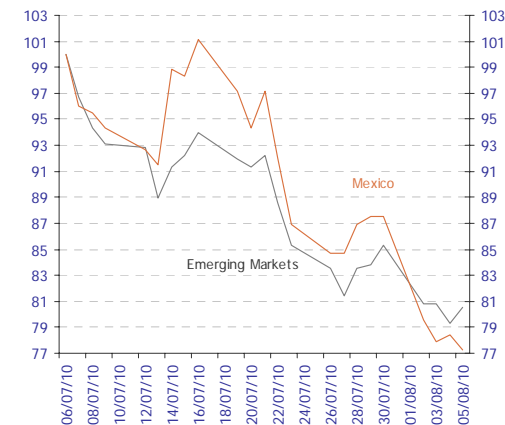
Markets

Chart 8
Stock market: MSCI indices (July 6, 2010 index = 100)



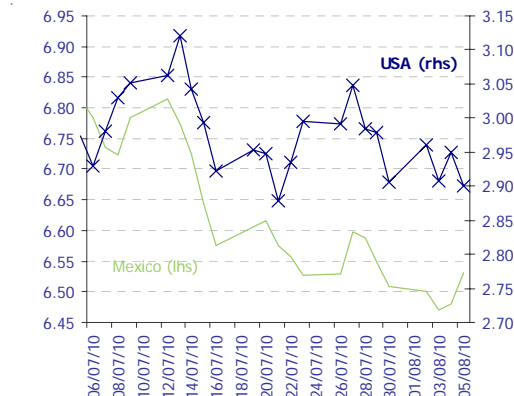
Source: Bloomberg and BBVA Research

Chart 10
Risk: EMBI+ (July 6, 2010 index = 100)



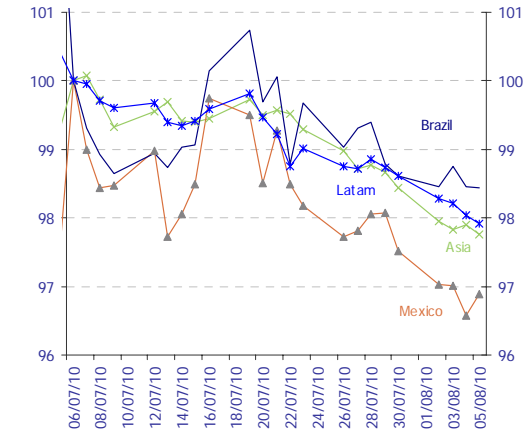
Source: Bloomberg and BBVA Research.

Chart 12
10-year interest rates*, last month



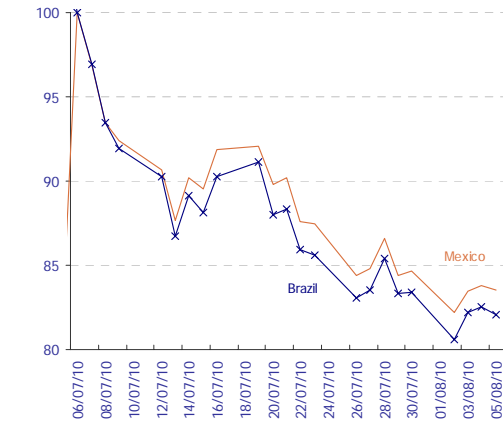
Source: Bloomberg and BBVA Research.

Chart 9
Foreign exchange: dollar exchange rates (July 6, 2010 index = 100)



Source: Bloomberg and BBVA Research
Note: LatAm includes Argentina, Brazil, Chile, Colombia and Peru. Asia includes the Philippines, South Korea, Taiwan, Singapore, Indonesia and Thailand. Non-weighted averages

Chart 11
Risk: 5-year CDS (July 6, 2010 index=100)



Source: Bloomberg and BBVA Research.

Chart 13
Mexico carry-trade index (%)



Source: Bloomberg and BBVA Research.

In line with the currencies of other emerging economies, the peso recovered ground on the dollar, being one of the best performing currencies in the region

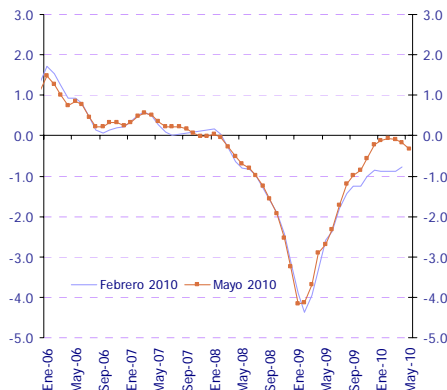
Mexico's country risk premiums are continuing to adjust downwards.

Faced with doubts about growth in the USA, there has been a slight increase in long-term domestic rates.

Economic activity, inflation, monetary conditions

Chart 14

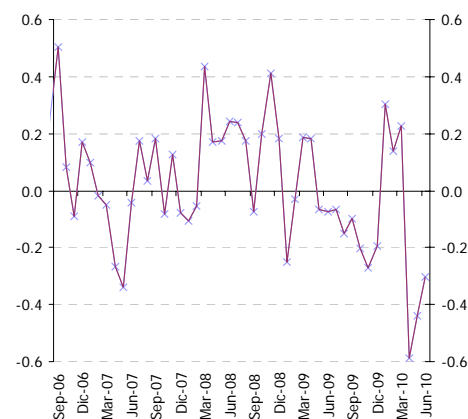
Economic Cycle Indicator (standardized)



Source: BBVA Research with data from INEGI, AMIA and BEA. The weighted sum of 21 different indicators of economic activity, spending and expectations based on trend series.

Chart 16

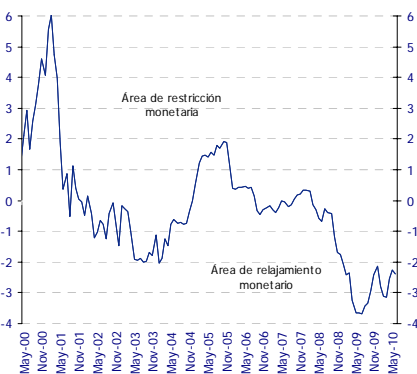
Index of Inflationary Surprises (CPI, % mom, Observed-Estimated, pp)



Source: BBVA Research, with data from Banxico on the monthly surveys of expectations of specialists in the private-sector economy.

Chart 18

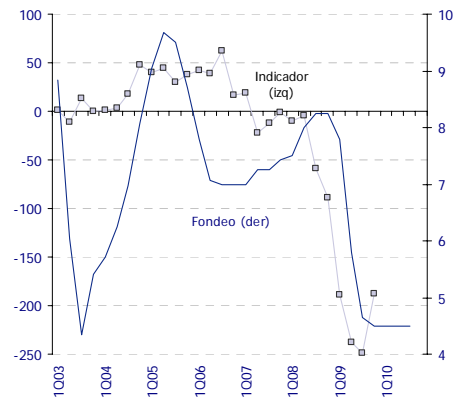
Index of monetary conditions



Source: BBVA Research

Chart 15

Indicator of inflationary demand pressures and bank lending rates (standardized index & %)



Source: BBVA Research and Banxico

Chart 17

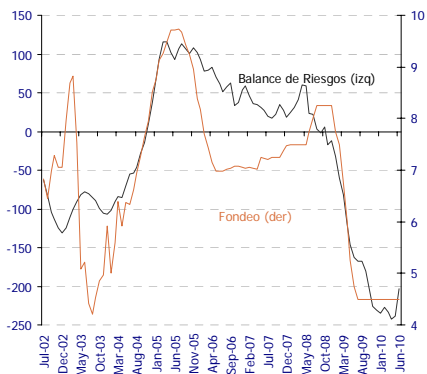
Index of Economic Activity Surprises (2002=100)



Source: BBVA Research with Bloomberg data. Difference between the registered data and the Bloomberg consensus for seven variables of economic activity in Mexico. Standardized index. Rises (falls): positive (negative) surprises.

Chart 19

Balance of inflationary risks* and interest rates (standardized and %; monthly av.)



Source: BBVA Research. * Standardized and weighted index (between inflation and economic growth); it uses economic indicators of economic activity and inflation. A rise in the index points to a greater weight of inflationary risks over growth risks and thus a greater possibility of monetary restriction.

The Mexican economy is in better shape than a few months ago, but the monthly rate of recovery appears to be slowing. Domestic demand continues to lag behind foreign demand as a driving force for growth.

With respect to the consensus, the inflationary surprises are downward and show stabilization after a long positive period.

Monetary conditions are relaxed: they are not slowing growth. No rush to raise monetary rates

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