Mexico

Weekly Watch

August 27, 2010

The week to come

Economic Analysis

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Market analysis

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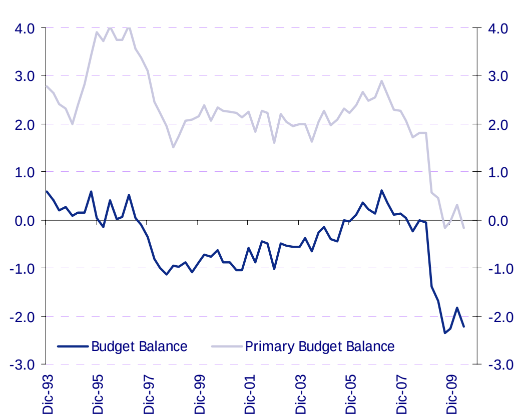
Waiting for the 4th Government Report and the 2011 Draft Budget

This week will see the release of a number of indicators which are in themselves not particularly important – manufacturing sector and consumer confidence- but which are useful as they relate to August and therefore give a guide to other indicators, such as the profile of consumer spending in 3Q10. This week also sees more relevant economic policy news with the release of the 4th Government Report by the President to Congress, commenting on the Government's activity in the year and the budget for the next legislative period. Figures on public sector finances in July will also be published on Monday. Irrespective of the erratic nature of monthly figures for public sector income and spending, it would seem that despite the economic recovery and the increases in taxes and tariffs the budget balance remains at levels similar to 2009, at around 2% of GDP. This does not seem to be particularly high, particularly in today's global context, and the commitment to public finance stability is a strength which has been built up by successive governments. Nevertheless, this will have to be strengthened to provide a room maneuver in the event of any negative shocks in the future, improving the role of the budget as a cyclical stabilizer. There will be more information on these issues in two weeks time with the publication of the draft 2011 Budget.

The financial markets negatively differentiate Mexico within Latin America

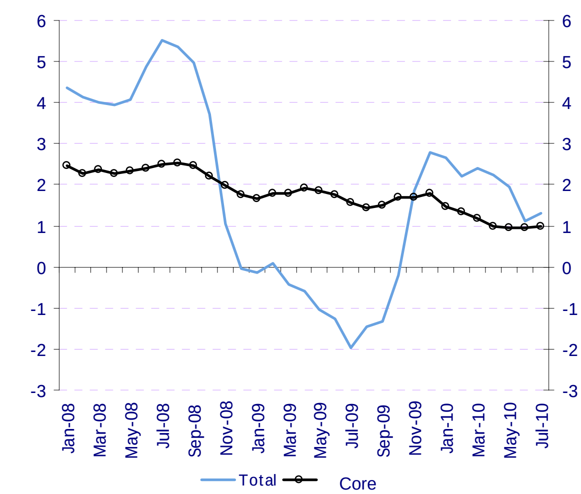
Unlike other Latin American countries, the fears of a sharper slowdown in the USA –following the release of negative real estate figures, the downward revision of 2Q10 GDP and the tone of Bernanke's recent statements— implied that the peso broke through the 13 ppd level, a devaluation that exceeded 1.9% compared to the start of the week. In addition, the MBonds curve has had its worst performance for 18 months. We expect the exchange rate to fall back from these levels if the recovery in stock market indices continues; however, MBonds could continue to be under pressure.

Chart 1
Mexico, Budget Balance (% GDP)



Source: BBVA Research with Banxico data

Chart 2
U.S., inflation (% yoy)



Source: BBVA Research with Datastream data

Economic Analysis

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Calendar: Indicators

August confidence indicators

Manufacturing sector, (September 2, 9:00 AM)
Forecast: 50.4% pts (SA) Consensus: N/A Latest figures: 51.2 pts. (SA) Manufacturing confidence

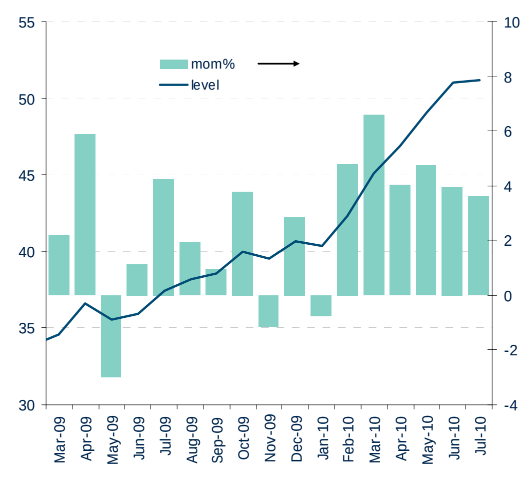
Consumer (September 3, 9.00 AM)
Forecast: 86.1% pts (SA) Consensus: N/A Latest data: 86.9 pts

Manufacturing and consumer confidence indicators will be published at the end of the week; these will be very interesting as they refer to the third quarter. Manufacturers are surveyed about their production, resource utilization, domestic demand, employment, export, stock, confidence and other levels. The dynamics of Mexican manufacturing are tightly linked to US manufacturing industry, where growth appears to be moderating, something which will be reflected in manufacturing confidence. July interrupted three months of improvements in consumer confidence. A labor market which is displaying stubborn unemployment levels and high levels of under-occupation, despite increasing employment, is consistent with consumer confidence which is not increasing significantly.

July Monthly Public Finances Report

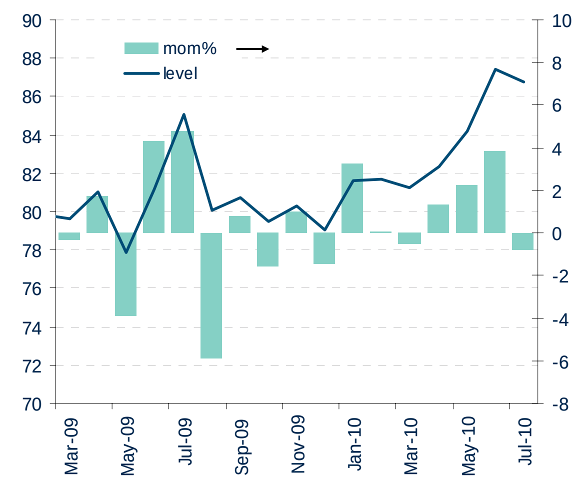
The report on public finances in July will be published on Monday. After the budget deficit reached 2.2% of GDP in 2009 (2.5% in terms of PSBR), after three years of continuous balance, some tax increases (Sales Tax permanently increased from 15% to 16%, and temporary increases in income tax rates) have been approved in order to balance the budget and reduce dependency on oil revenues. However, the results in mid-2010 are somewhat limited. Public sector income has grown, but so has the economy, unlike in 2009. As a result the share of public sector income to GDP is 22.5%, only 0.1 points higher than in 2009, despite the tax increases. Whilst it is true that specific tax revenue has grown faster (from 8.9% of GDP in 2009 to 9.5% in 2010), non-tax revenue is growing less rapidly than the economy. In this situation of very limited improvement in revenue despite the recovery in the economy and higher tax rates, it will be particularly interesting to monitor the 2011 budget which will be presented in September. Adjustments to revenue –new taxes? more efficient tax collection?- and/or spending cuts, at least as a share of GDP, may be announced to facilitate deficit reduction.

Chart 3
Manufacturing Confidence
(Level and Change mom %)



Source: BBVA Research with INEGI data

Chart 4
Consumer confidence
(Level and Change mom %)



Source: BBVA Research with INEGI data

Market analysis

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Markets

The negative differentiation of Mexican markets compared to other countries in the region has increased…

The negative differentiation of Mexican markets compared to other countries in the region is reflected in the exchange rate, which closed the week down 1.88%, and also in the MBond curve, which had its worst performance for 18 months (especially on the long stretch, which had been the favorite of Afores pension funds and foreign investors). The rate for the June 20 reference bond ended the week up 27 bps (to 6.22%). The performance of bonds is interesting, as until last week expectations of lower economic growth had benefitted Bonds due to the pricing in of lower inflationary pressures and a longer period of loose monetary policy. However, last week's change reveals an increased prevalence of a higher risk premium even for fixed income instruments, resulting in the exchange rate ending the week above the psychological barrier of 13 (at 13.01) after having reached levels of around 13.10. We expect the exchange rate to fall back from these levels if the recovery in stock market indices continues; however, MBonds could continue to be under pressure as an increased appetite for risk could continue to drive yields on American Treasury Bonds upwards (the rate for 10 year bonds was 17 bps up at the end of last week).

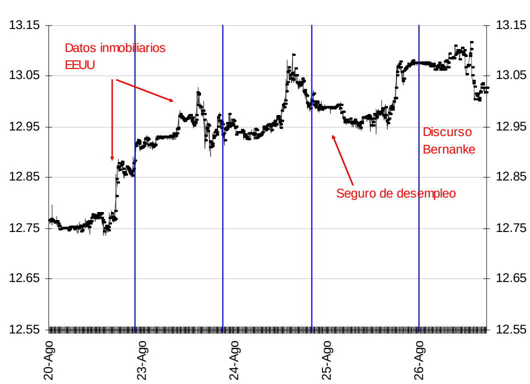
...despite the uncertain environment, international credit markets still have an appetite for Mexican assets

Despite the increase in risk premiums and the situation in international credit markets, Pemex (BBB/BBB/Baa1) managed to place US$1,000 million in the market in dollars by reopening a bond maturing in 2035. This is the third time that the state-owned company has issued instruments on the international market, having issued US$4,000 million so far this year. International credit markets continue to have an appetite for Mexican assets, and some companies have taken advantage of this, and low finance costs, to raise funds.

The new composition of the IPC stock market index will start to be used from September 1

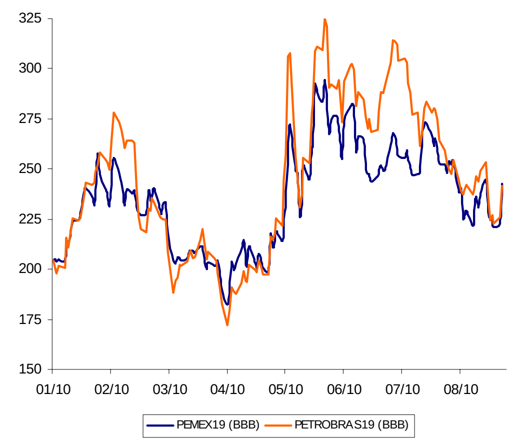
On 6 August, the BMV announced the addition of Arca, Chdraui, Ich and Lab to the IPC (Stock Prices and Listings Index) from 1 September to 31 August 2011: the companies removed from the IPC are Autlan and GFamsa. In addition, Arca has been added to the Rentable index. These two indices are the basis for the main Mexican trackers, Naftrac and Mextrac. It should be remembered that, depending on the volumes resulting from the change in the indexed portfolios, the companies which will benefit most will be Ich, Chdraui, Femsa and TVaztca. The most affected would be Asur, Gfamsa, Autlan and Gruma. Based on our estimates for each of the companies listed in the IPC and Rentable indices, from September 1, the valuation of the second appears to us to be more attractive, as it will be listed at a discount of 14.0% and 12.5% in terms of Price/Earnings multiples for 2010 and 2011, respectively. The IPC multiples (Naftrac) for these years are 15.9x and 13.8x; whilst the Rentable (Mextrac) has multiples of 13.7x and 12.1x, respectively.

Chart 5
Mexico: MXN daily performance



Source: BBVA Research with Banxico data

Chart 6
Pemex and Petrobras: Spreads for comparable bonds with 2019 maturity



Source: BBVA Research with Bloomberg data

Technical Analysis

Market analysis

Equity

Technical Analysis

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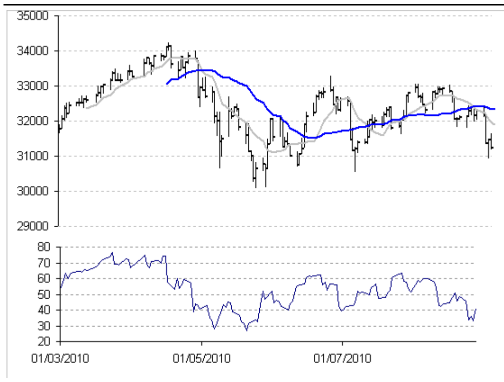
IPC

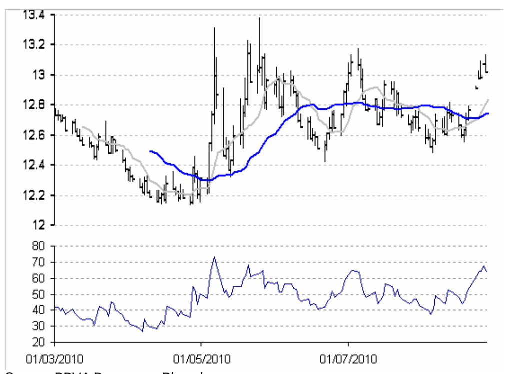


Source: BBVA Bancomer, Bloomberg

IPC: The IPC broke downwards through the 200 day moving average, establishing a negative short-term trend. It quickly reached a new support level at around 31,000pts. We believe that there could be a short-term rebound, but so long as this does not break upwards through 32,000pts, we only consider this change to be a pullback within the upward trend.

Previous recommendation: As long as it keeps in this territory, there will be no short-term technical exit sign.

MXN

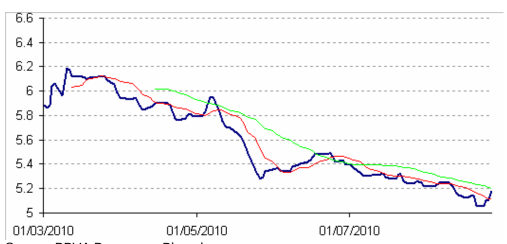


Source: BBVA Bancomer, Bloomberg

MXN: Broke upwards through the P$12.80 barrier, to above P$13.00. We are seeing short-term over-buying, and we believe that this change should be limited to ranges of P$13.15/13.20. We expect it to return to its adjustment path in the short-term.

Previous recommendation: We believe it should continue to operate in the same range of from P$12.50 to 12.80 in coming days.

3-YEAR M BOND

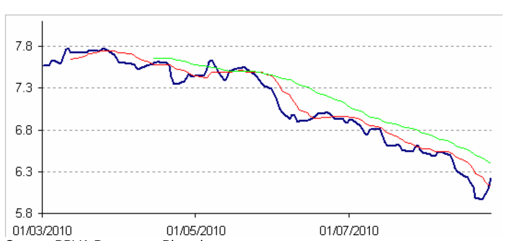


Source: BBVA Bancomer, Bloomberg

3-YEAR M BOND: (yield): Finally recovering to levels above the 10-day moving average. As we have stated, a change in trend will only be established when it breaks through the 30-day moving average, at levels of 5.205 with the next objectives being 5.35 and 5.50.

Previous recommendation: With this new decline, a change in the trend can be considered when it breaks 5.24.

10-YEAR M BOND



Source: BBVA Bancomer, Bloomberg

10-YEAR M BOND: (yield): Recovering to levels above the 10-day moving average. We consider that this recovery can be maintained, at least to levels of around 6.40 where it will meet resistance from the 30-day moving average.

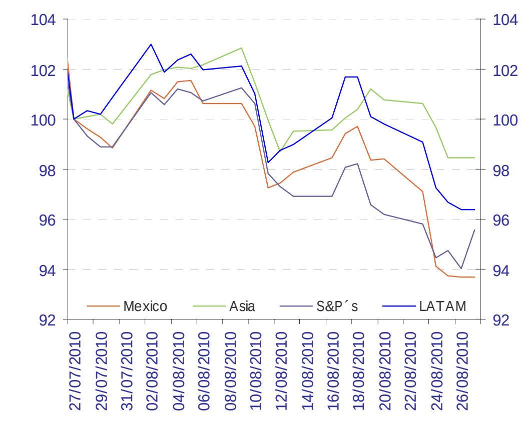
Previous recommendation: Averages remain on a clearly downward trend and any technical rebound is limited to the 6.33 and 6.51 territory.

Source: BBVA Research with Bloomberg data

Markets

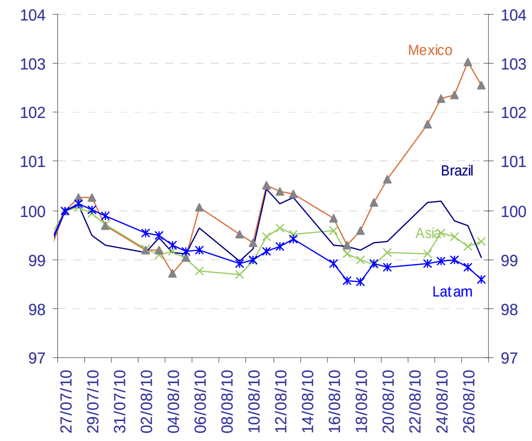
Differential weakness of the peso faced with greater uncertainty about the US economy and the effects on domestic activity.

Chart 8
Stock Market: MSCI indices (July 27 index 10=100)



Source: Bloomberg and BBVA Research

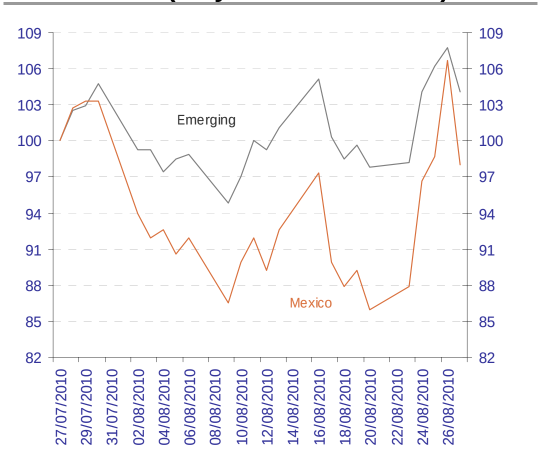
Chart 9
Foreign exchange: Dollar Exchange Rates (July 27 index 10=100)



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

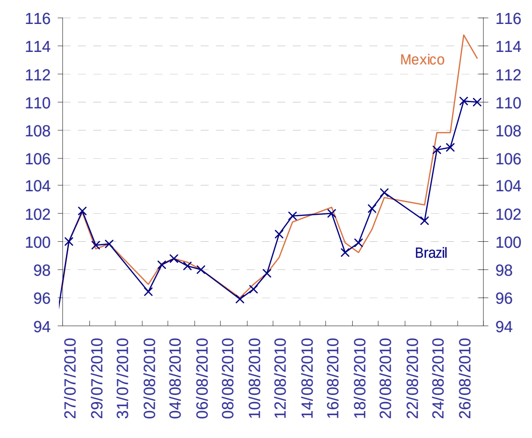
Mexico country risk as a function of the cyclical risk premium

Chart 10
Risk: EMBI+ (July 27 index 10=100)



Source: Bloomberg and BBVA Research.

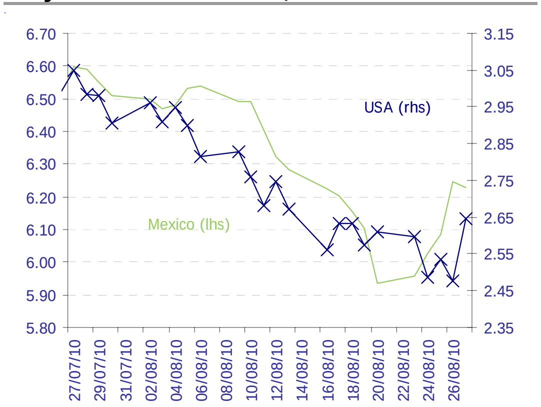
Chart 11
Risk: 5 year CDS (July 27 index 10=100)



Source: Bloomberg and BBVA Research.

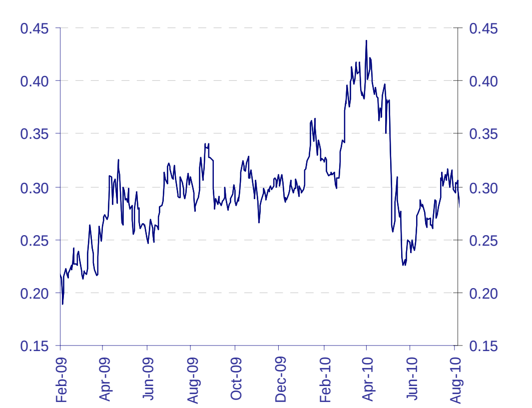
Long-term rates are returning to the levels prior to Banxico's monetary policy decision last week

Chart 12
10-year interest rates*, last month



Source: Bloomberg and BBVA Research.

Chart 13
Mexico carry-trade index (%)

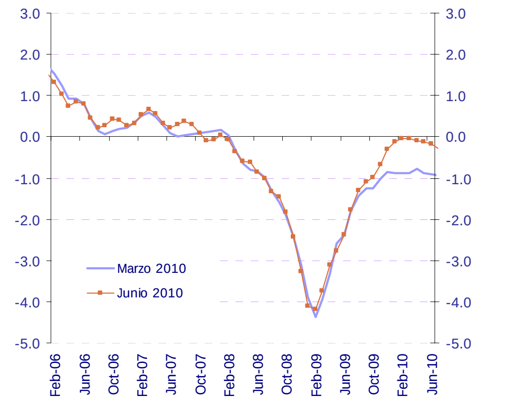


Source: Bloomberg and BBVA Research.

Economic activity, inflation, monetary conditions

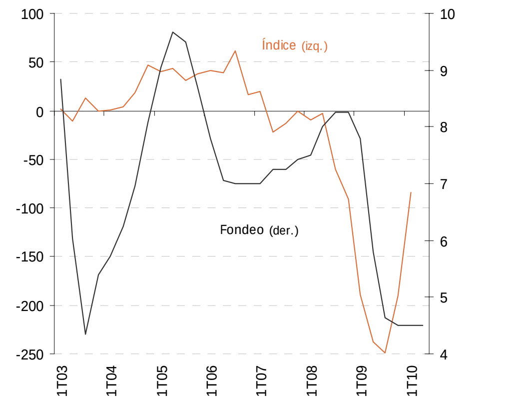
The Mexican economy is in better shape than a few months ago, but the monthly rate of recovery appears to be slowing. Domestic demand continues to lag behind foreign demand as a driving force for economic activity.

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.

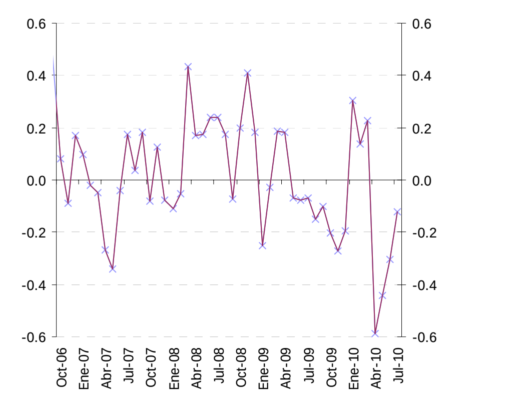
Chart 15
Indicator of inflationary demand pressures and bank lending rates (standardized index & %)



Source: BBVA Research and Banxico

Compared with the consensus, inflationary surprises are still downward, while in economic activity they are beginning to be slightly upward

Chart 16
Index of Inflationary Surprises
(CPI, % mom, Observed-Estimated, pp)



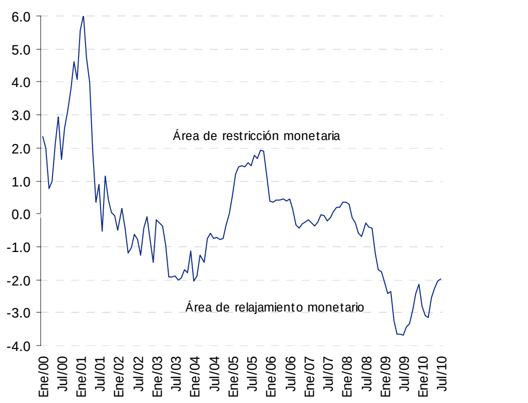
Source: BBVA Research, with data from Banxico on the monthly surveys of expectations of specialists in the private-sector economy.

Chart 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.

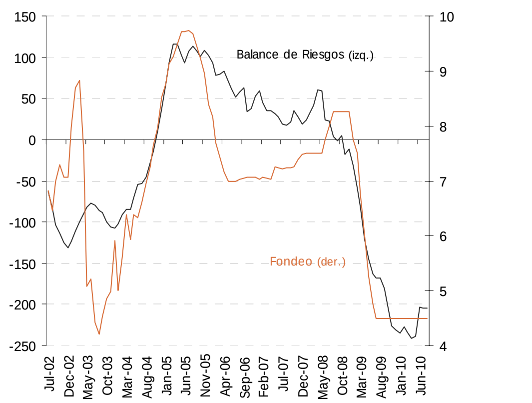
Monetary conditions are accommodative and are not a brake on growth. No rush to raise monetary rates

Chart 18
Index of monetary conditions



Source: BBVA Research

Chart 19
Balance of Inflationary Risks* and Lending 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 IBR points to a greater weight of inflationary risks compared to growth and thus a greater possibility of monetary restriction.

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