Mexico

Weekly Watch

September 24, 2010

The week to come

Economic Analysis

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Market Analysis

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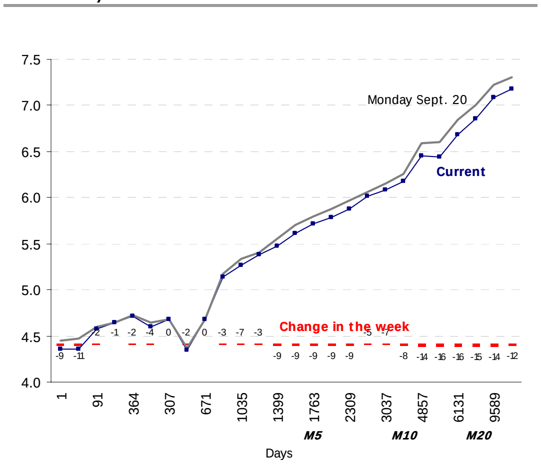
Mexico: prospects of moderate economic activity and subdued inflation.
Keeping with the tone of the press release by Banxico this Friday the 24th, Mondays's publication of the July IGAE (Economic Activity Index), for which we expected a monthly fall, will confirm the moderation of economic activity at the beginning of 3Q 2010. It is described as *"a moderation in the growth rate"* according to the Mexican central bank language. Therefore we do not rule out a quarter GDP fall in 3Q10. With respect to prices and consistently with the lag in private demand, Banxinco expects that inflation will remain under the lower limit of the current forecast over the coming quarters, which implies a continuation of the Mexican economy's disinflation process.

The Fed is ready for a new quantitative adjustment in monetary policy…
The main question to answer before the FOMC statement on Tuesday was to what extent the committee would lean toward additional "quantitative flexibility" measures in the enactment of monetary policy (QE2). After the statement, there are no doubts about the central bank's focus no longer being the economic recovery but rather the risks of deflation, with the acceptance that current inflation levels are "somewhat lower" than those compatible with its objectives. It is very probable that this additional adjustment of monetary policy will be announced at the beginning of November, once the Fed has revised its economic forecasts.

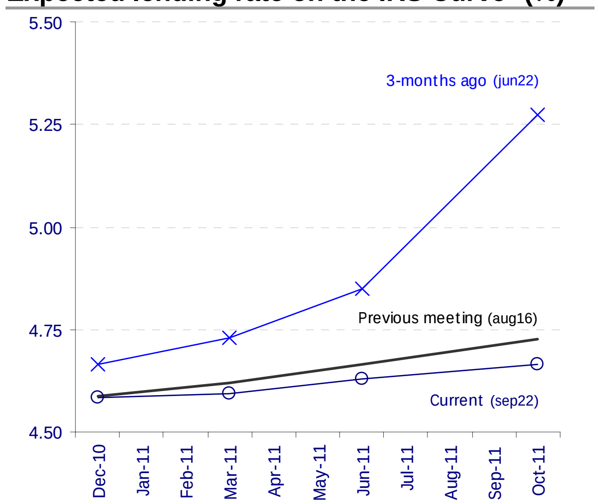
…which translated in depreciations of the dollar compared to global currencies, including the Mexican peso, and which helped to extend the rally in the long part of the curve.
Against this monetary background in the US, the currency appreciated by 1.9% (closing under the 50-week rolling average) and without significant changes in implicit volatilities. We consider that the currency could be subjected to an important support level of 12.50. As for long-term bonds, the situation caused a continuation of the rally for 10-year terms. Over the coming days we expect to see a scenario with lateral movements in these bonds.

Chart 1
Mexico, interest rate curve



Source: BBVA Research

Chart 2
Expected lending rate on the IRS Curve* (%)



Source: BBVA Research with Valmer data. *Implicit lending rate: adjusted for the equilibrium *spread* between the TIIE (equilibrium interbank interest rate), the Lending Rate and the term premium for the IRS curve.

Economic Analysis

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Calendar: Indicators

July IGAE

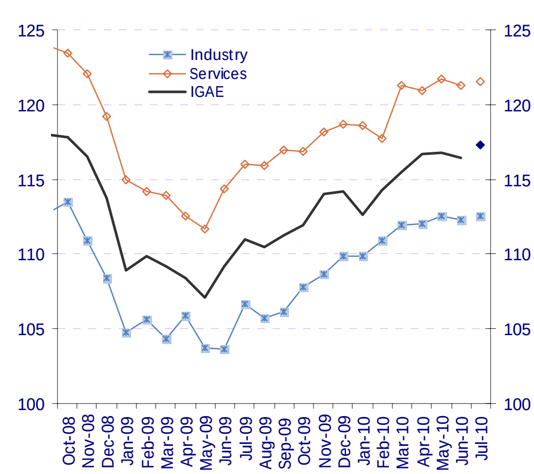
Monday 27 September, -0.2% month-on-month SA (4.6% year-on-year), Consensus: N/A. Previous: -0.4% month-on-month (6.6% year-on-year)

Economic activity in July will have continued to decelerate due to lower external demand and limited activity in the internal market. Now that the hard data of the manufacturing sector and some others concerning employment and services are known, we estimate that the monthly variation of the IGAE will be negative although probably not so much as one report ago. It is necessary to recall the negative surprise in the July manufacturing result as well as the sluggishness of indicators linked to internal demand such as services and retail sales. It is also important to consider that even though formal private employment continues to grow positively each month, this growth rate has slowed, in addition to the fact that this employment represents a fraction of the total labor force, which is mainly characterized by stagnating or slumping real salaries. With regard to the IGAE, we expect a reduction of –0.2% month-on-month (4.6% year-on-year), with a monthly variation of 0.3% in manufacturing, –0.1% in services, and an increase of 1% in agriculture, all being seasonally adjusted data.

Disinflation in the Mexican economy, more acute than expected by analysts at the closing of 2009 but consistent with previous data.

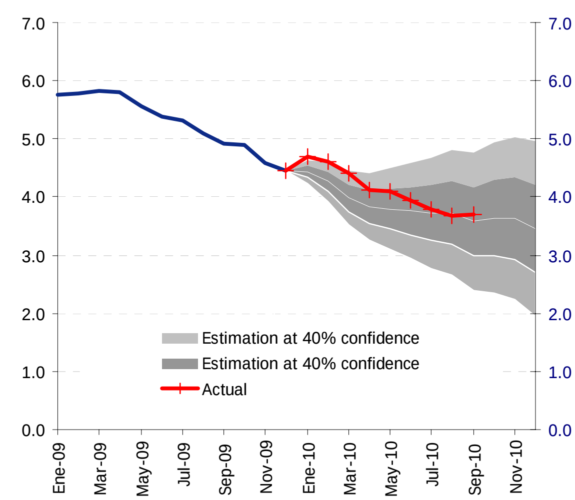
Was the downward behavior of inflation so far seen in 2010 foreseeable with the information available in 2009? Obviously not if we review the analysts' consensus at the end of 2009, which were much higher than the figures recorded up to this point. The error is without doubt attributable more to the unexpected behavior of the variables that determine inflation (lower demand, good performance in production and agriculture and fishing prices) than to an inappropriate methodological estimation of the behavior of prices. But curiously, these errors in forecasting other factors lead to inflation that is far from the levels expected by analysts but much closer to less elaborate forecasts. This is what can be seen in the chart below for annual core inflation. The results show that the disinflationary process was foreseeable if we had not taken into consideration more variables, perfectly entering within the confidence range given for time series models that do not factor in more information than the data itself. The forecasts are only out of the confidence range in January given that the fiscal changes were not included in the December data. However, since February inflation has tended toward the center range of the forecast, displaying its transitory character, which is to be expected given the current background of lower demand pressures.

Chart 3
IGAE (y-o-y % change and components)



Source: BBVA Research with Inegi data.

Chart 4
Core inflation, data and forecasts with information up to Dec. 09 (Var. % y-o-y)



Source: BBVA Research with Banxico data

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Markets

Appreciation of the peso (MXN) in a global outlook presenting greater possibility of intervention of the Federal Reserve in the US; the currency could receive important support at a level of 12.50 in upcoming sessions.

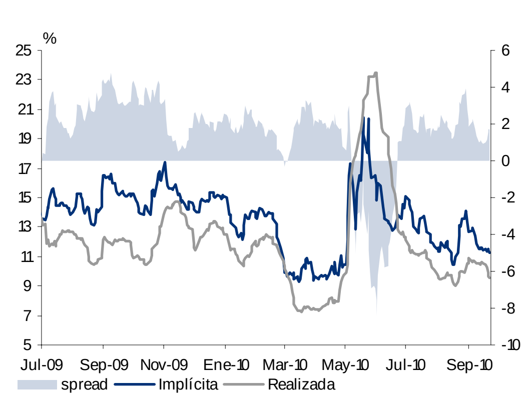
Over the last week the dynamic of global currencies was determined by the Fed's statement —which increases the possibility of enacting a QE2— and by US cyclical indicators which, presenting a negative differentiation, resulted in a depreciation of the dollar compared to the main currencies (e.g. the DXY index fell by 2.4%).

In this context the peso showed a lower reaction margin to the stock market indices or to the US Treasury Bills, recovering a positive correlation with the euro. Thereby, the currency appreciated by 1.9%, closing below the 50-week rolling average. For the time being, we consider that the currency could be subjected to an important support level of 12.50. In fact, implicit volatilities remained without significant changes (the volatility of 1M dropped by 0.1 vegas) and have limited fall space left. In addition, it is worth stressing that this week US$534 m. of the Banxico shares that remained open were exercised (meaning that only US$5 m. are left). Therefore, we expect a consolidation trend over the coming days.

Long term rates accumulated gains over the previous week in keeping with US Treasury bonds.

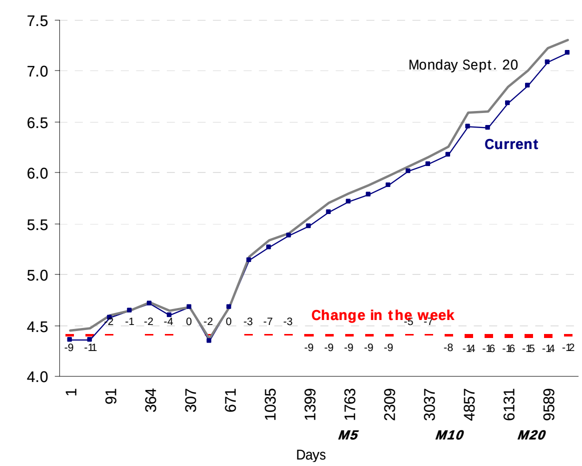
Against this global backdrop, bonds accumulated gains over the last week, for instance in only two days the M10 saw a rally of 14pb. This movement is in line with the Treasury Notes rates, which accumulated gains of 12 and 19 pb in 2 and 10-year bonds in the first four days of last week. However, lesser aversion toward the end of the week favored a technical correction fostered by a take-up of utilities in international and local bonds. We hope that over the coming days a lateral movements scenario will prevail, and in a range limited to the medium and long part of the curve until we have new economic data forecasts for the US.

Chart 5
MXN: implied vs. historical volatility (1M)



Source: BBVA Research with Bloomberg data

Chart 6
Mexico, interest rate curve



Source: BBVA Research with Bloomberg data

Technical Analysis

Market Analysis
Equity

Technical Analysis

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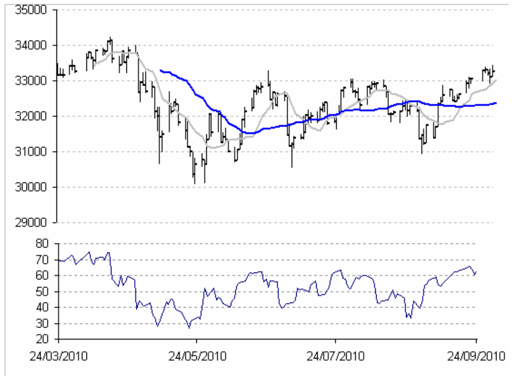
IPC stock market index

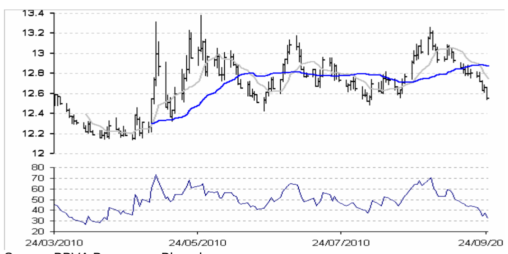


Source: BBVA Bancomer, Bloomberg

IPC: the IPC finally reaches a level above 33.000pts, with this level maintained all week and now converting in short-term support. After this break, the next objective short-term level is at the 34,000/34,200 pts zone, a positive prospect maintained as long as it continues to operate above the aforementioned support.

Previous recommendation: Some oscillators such as the RSI and MACD suggest that the upward trend may be maintained over the coming sessions, with a first technical level being the same level of 33,000 points.

MXN

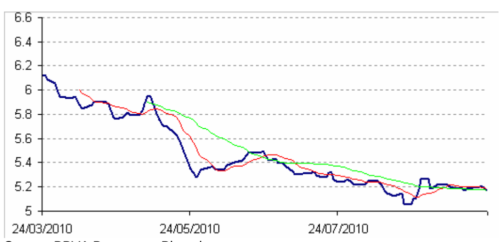


Source: BBVA Bancomer, Bloomberg

MXN: Continues its clear adjustment trend and is now below the 200-day rolling average. The next support is at P$12.50, where the most recent rebound occurred. Below this level the next floor would be at P$12.40 and subsequently down to P$12.20, while the resistance is at P$12.74.

Previous recommendation: We believe it will find support in the 200-day rolling average at P$12.78.

3-YEAR M BOND

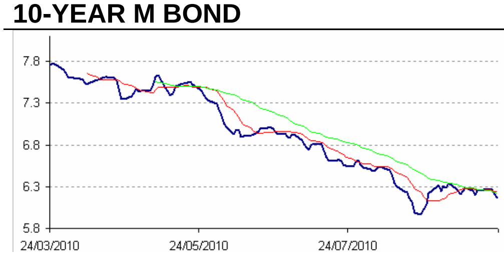


Source: BBVA Bancomer, Bloomberg

3-YEAR M BOND (yield): lateral week, but still cannot bounce back to zones above the short-term rolling averages. There is still a chance of returning to 5.10.

Previous recommendation: There is a possibility of returning to the 5.10 zone.

10-YEAR M BOND



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

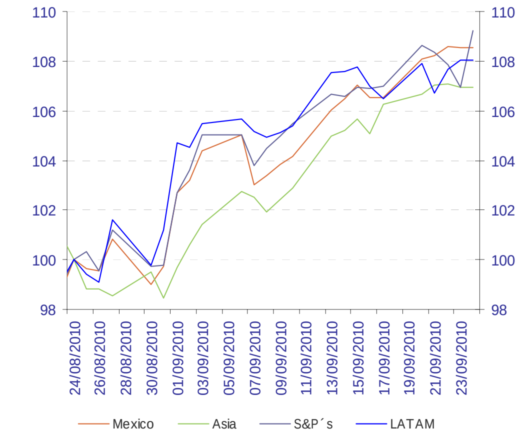
10 YEAR M BOND: (performance): Continues to be below rolling averages of 10 and 30 days, with a possibility of returning to 6.0.

Previous recommendation: The negative trend will continue with possibilities of returning to the 6.0 zone.

Markets

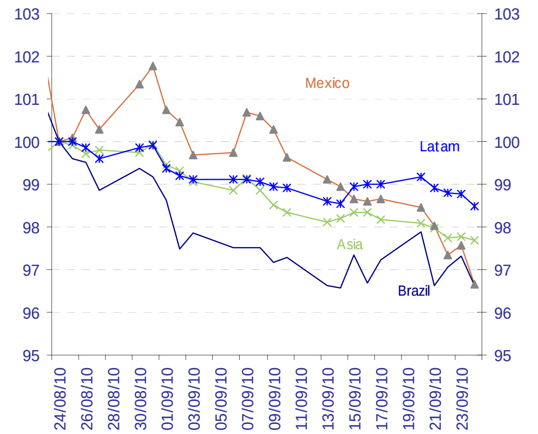
General currencies appreciation with respect to the dollar. The peso with a positive differentiation with respect to other currencies in the region.

Chart 7
Stock Market: MSCI indexes (24 August 2010 index = 100)



Source: Bloomberg and BBVA Research

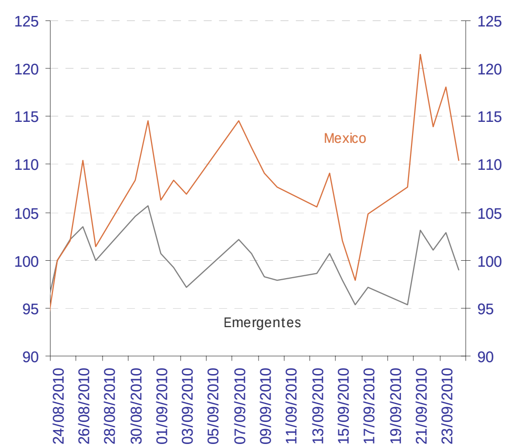
Chart 8
Foreign exchange: Dollar exchange rates (August 24 2010 index = 100)



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.

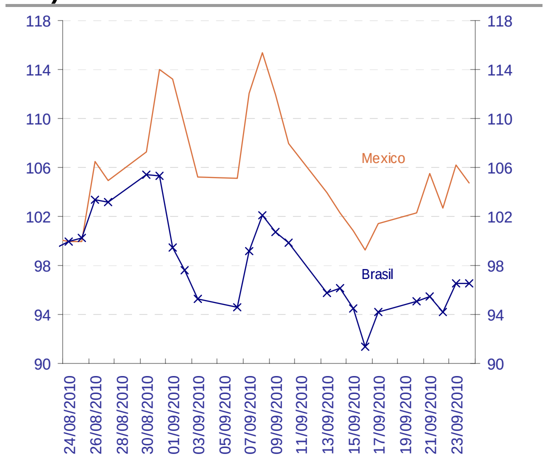
Volatility in sovereign risks of emerging countries relative to market uncertainty.

Chart 9
Risk: EMBI+ (Aug 24, 2010 index = 100)



Source: Bloomberg and BBVA Research.

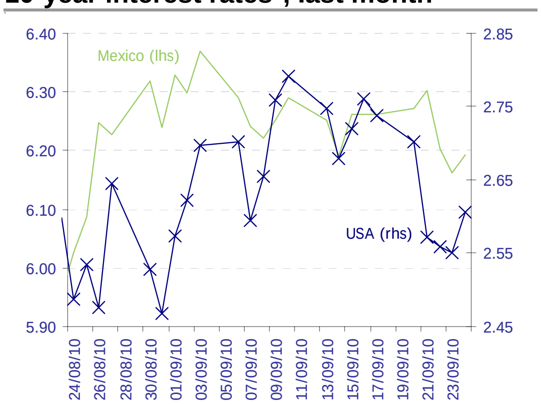
Chart 10
Risk: 5-year CDS (24 Aug 2010 index = 100)



Source: Bloomberg and BBVA Research.

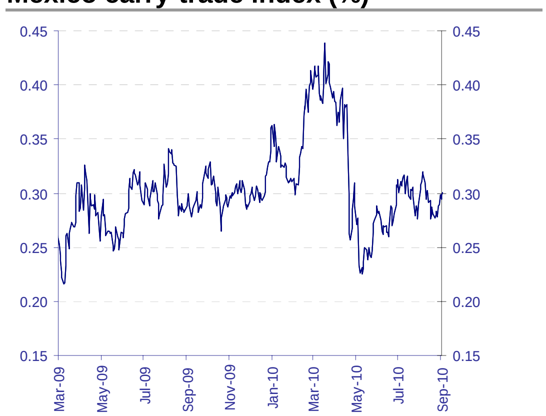
New rally in the long part of the curve with a rebound at the closing of the week.

Chart 11
10-year interest rates*, last month



Source: Bloomberg and BBVA Research

Chart 12
Mexico carry-trade index (%)

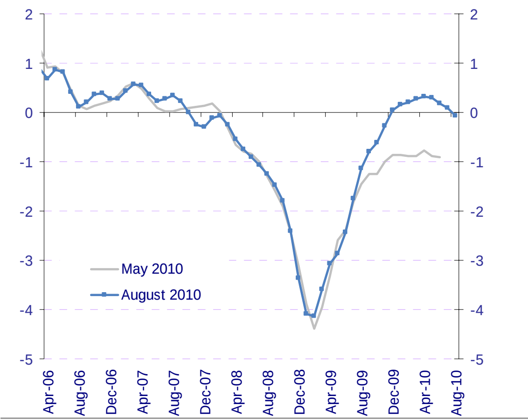


Source: Bloomberg and BBVA Research

Economic activity, inflation, monetary conditions

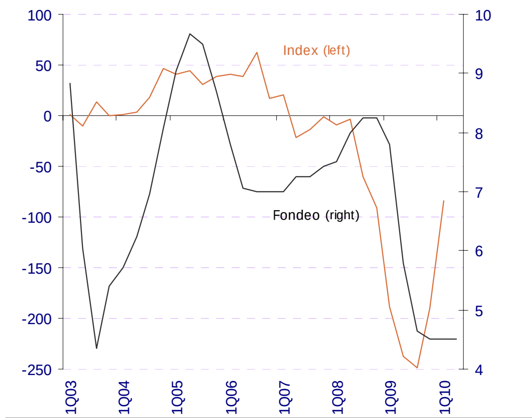
The Mexican economy is in better shape than a few months ago, but the monthly rate of recovery appears to be slowing.

Chart 13
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.

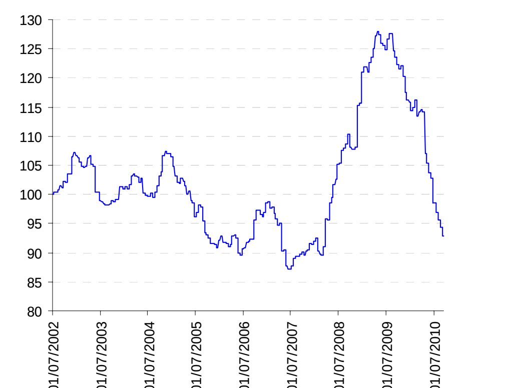
Chart 14
Indicator of inflationary demand pressures and bank lending rates (standardized index & %)



Source: BBVA Research and Banxico

Compared with the consensus, inflationary surprises are still downward

Chart 15
Index of Inflationary Surprises
(July 2002=100)



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

Chart 16
Index of Economic Activity Surprises
(2002=100)

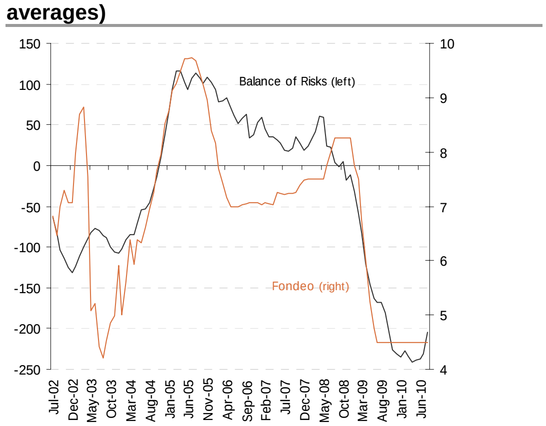
Source: BBVA Research with Bloomberg data Difference between the registered data and the Bloomberg consensus for seven variables of economic activity in Mexico. Standardized index. Rises (falls): positive (negative) surprises.

Monetary conditions are accommodative. No rush to raise monetary rates; no need to lower them

Chart 17
Index of monetary conditions

Source: BBVA Research

Chart 18
Balance of Inflationary Risks* and Lending Rates (standardized and %; monthly averages)



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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