

Mexico

Weekly Watch

October 15, 2010

Next week

Economic Analysis

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Market Analysis

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We do not expect any change in Banxico's funding rate until summer 2012

Today, Friday, Mexico's central bank noted the situation of abundant global liquidity flowing to emerging economies –including Mexico– in search of returns. The Bank's description of this is a first step –once additional relaxation in US monetary policy takes place– towards including this in the balance of risks for economic activity and inflation; this is particularly relevant in terms of the additional weakness of the dollar and the relative appreciation of the peso in the context of capital flowing into the country. Here at BBVA Research we already regard this situation of extremely lax monetary policy in the USA over a lengthy period to be the central case; as a result, we believe that in a domestic context for economic activity with no significant demand pressures and core inflation at historically low levels, Banxico will not change its monetary policy until an increase in summer 2012. However, if capital inflows and the appreciation of the Mexican currency intensify in 2011, Banxico may decide to reduce its base rate.

Global exchange and interest rates – no changes in the short term

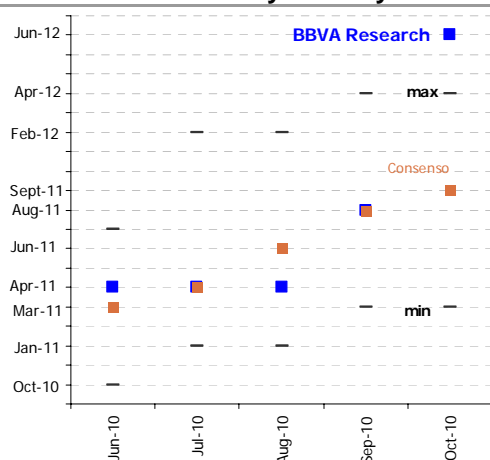
Monetary policy is driving exchange rate performance globally: the Fed is going to increase liquidity; the ECB does not seem to be given to additional relaxation through quantitative easing; and emerging economies are in a situation where they might have to adapt their interest rates and intervene to limit the rapid rises in their currencies. This outlook is not going to change before the G20 meeting in November.

The likelihood of high levels of liquidity resulting from quantitative easing in the USA is continuing to drive the performance of the peso, and demand from foreigners is setting the trend on the short stretch of the curve

Poor US economic figures at the end of the week reversed gains for the peso after the minutes were released. The upwards trend continues and we expect the currency to fluctuate in the range 12.30-12.45 in the short-term. Demand from foreigners is still determining the trend on the short stretch of the curve (1d to 1y), taking advantage of the arbitrage opportunity in the forward MXN market.

Chart 1

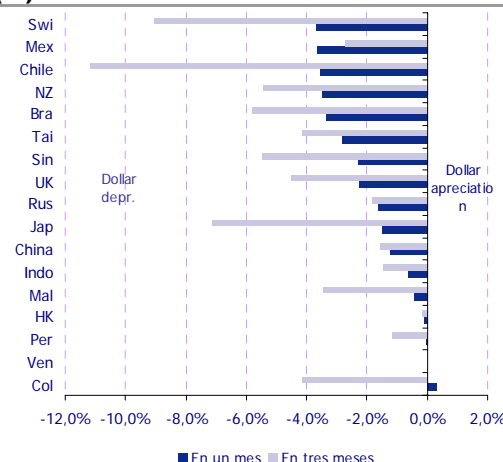
The outlook for an increase in the funding rate based on a survey of analysts



Source: BBVA Research and Banamex survey

Chart 2

Exchange Rate vs USD, percentage change (%)



Source: Bloomberg & BBVA Research

Economic Analysis

Calendar: Indicators

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Inflation for the first two weeks in October

Friday, October 22: 0.46% mom (3.87% yoy) Consensus: 0.38% mom Previous: 0.40% mom (6.1% yoy)

On Thursday, inflation figures for the first two weeks of October will be released: we forecast that inflation will experience its first significant increase in annual terms, increasing from 3.65% yoy in the first two weeks of September to around 3.9%. This increase is mainly due to pressures from non-core components affected by the start of winter electricity prices and significant pressure from agricultural markets, which are seasonally consistent but which may also reflect the adverse effects on agriculture of the heavy rains in some states in September. Core inflation will remain under control in the absence of exchange rate pressures and lower than expected demand; as a result of these factors, we forecast that it will increase by 0.24% in the quarter, reaching an annual level of 3.62%. Whilst we forecast that there will be an increase in inflation in 4Q10, this is consistent with our inflation forecast of around 4.6% yoy at the end of 2010.

August retail sales and unemployment in September

Sales: Wednesday, October 20: 0.42% mom (2.5% yoy) Consensus: N.A. Previous: 0.0% mom (1.1% yoy)**Unemployment: Friday, October 22: 5.1% Consensus: N.A. Previous: 5.2%**

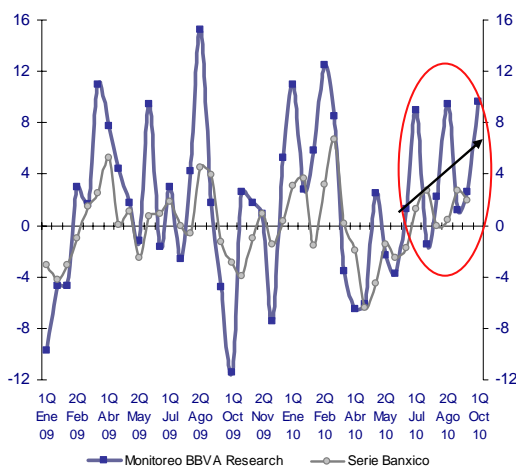
We expect to see a slight increase on previous figures -which were static- in the retail sales reported on Wednesday, with sales in August having increased by around 2.5%. It should be noted that retail sales indicators -such as consumer confidence and sub-indices of this such as the ability to acquire durable goods- are still below their pre-crisis maximums, even though they have risen slightly.

September's unemployment rate will remain relatively high, at around 5.1% in seasonally adjusted terms. This unemployment rate is equivalent to around 2.5 million people. The persistence of high unemployment rates may be related to job creation being concentrated in sectors such as manufacturing which are capital intensive.

Both of these indicators are continuing to reflect the limited growth in domestic demand and the slowdown in growth in foreign demand.

Chart 3

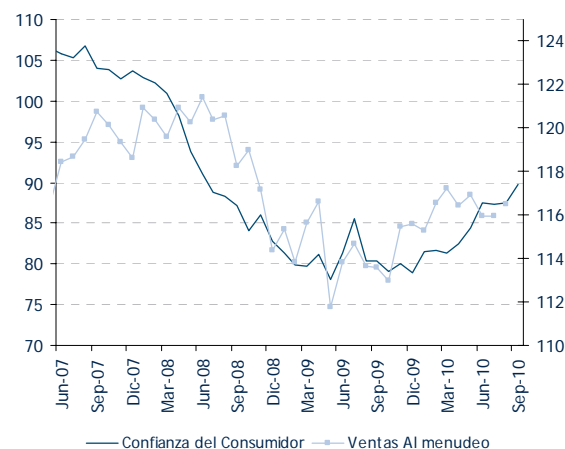
BBVA Research monitoring of agricultural prices and the Banxico agricultural prices index (% fortnightly change)



Source: BBVA Research with Banxico and SE data

Chart 4

Consumer confidence and retail sales (Index 2003=100)



Source: BBVA Research and INEGI

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Markets

The monetary outlook in the USA continues to affect the performance of the peso, and poor US economic activity figures will temper gains in the currency

Whilst the main determining factor for the peso continues to be related to expectations of QE2 by the Fed, a number of nuances are arising. Worse than expected US figures at the end of the week (e.g. employment insurance and inflation) resulted in profit taking causing a return to a zone around 12.45, having reached lows of 12.32 on previous days. However, the currency remains below 12.50, and therefore the peso continues to be on an upwards trend.

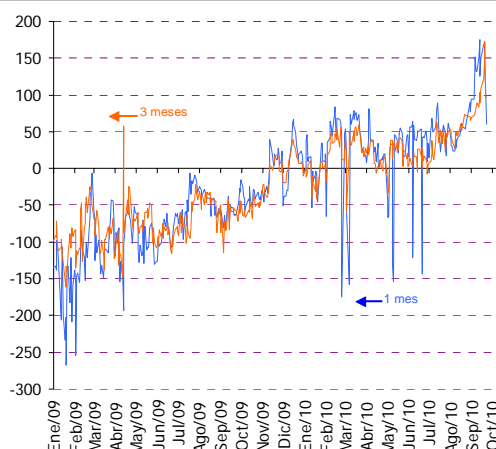
Three factors are particularly important in terms of positioning: firstly, the weekly increase in 1M implicit volatility of 0.50 vegas; secondly, during the week the remaining US\$100 million of Banxico options were exercise; and thirdly, the long speculative position in the MXN on the CME remained practically unchanged at US\$3.4 bn (up just US\$38 million, a weekly increase of 1.1%). As a result of these factors, we expect the currency to fluctuate in the range 12.30-12.45 in the short term.

Demand from foreigners is setting the trend on the short stretch of the curve, and the expected monetary intervention will have an effect on the flattening of the medium-short stretch

Demand from foreigners is continuing to set the trend on the short stretch of the curve (one day to one year), taking advantage of arbitrage opportunities in the forward MXN market (implicit domestic rates in forward markets lower than short-term local rates). These strategies have been accelerated by increasing expectations of the implementation of larger global monetary stimuli and, as a result, strengthening of the peso. During the week, the scale of the arbitrage reduced as a result of the increased demand for forwards and profit taking on the peso.

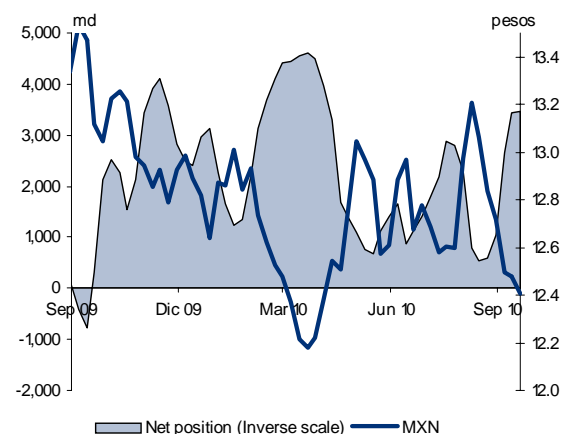
The debt curve is resisting a context of increased elevation of the curve; however, there was a slight increase in the slope during the week. We consider that the expected US monetary action in the context of a slowdown will once again have an effect on the flattening trend of the curve, particularly in the medium and short-stretches.

Chart 5
Spread between Cetes federal government bonds and implicit rates on the forward curve (bp)



Source: BBVA Research with data from Bloomberg

Chart 6
MXN: Long Non-Trading Positions in CME (US\$mn)



Source: BBVA Research with data from Bloomberg

Technical Analysis

Market Analysis

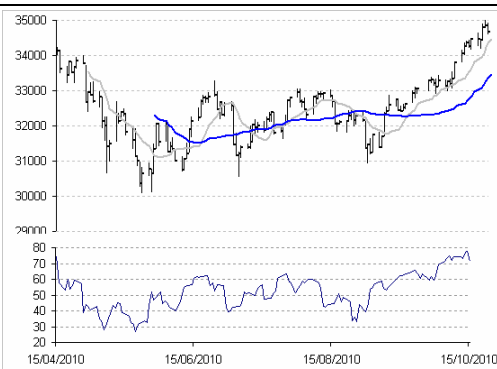
Equity

Technical Analysis

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CPI stock market index

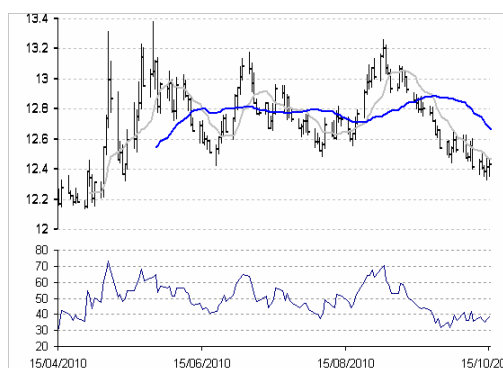


Source, BBVA, Bancomer, Bloomberg

CPI stock market index: The CPI continues reaching new historic highs, having approached 35,000 pts on a couple of occasions, from where it has shown day-to-day adjustments. Over-buying remains high and the spread between short-term oscillations is now up to 1,000 pts. We recommend profit taking and expect an adjustment to where the support level has become established at 33,450 pts.

Previous recommendation: We recommend reducing positions and forecast movement to support levels of 33,700 pts and 33,000 pts.

MXN

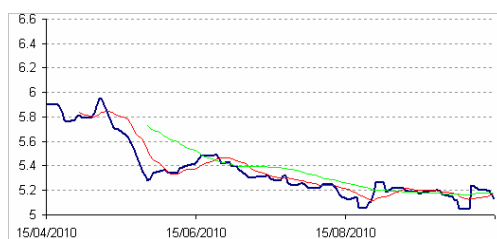


Source, BBVA, Bancomer, Bloomberg

MXN: The MXN has not managed to return to levels above P\$12.50, so the downward trend continues. The floor of P\$12.38 has been tested and respected, but in order to consider that there has been a change in the short-term trend, it has to break through the 10 day moving average (P\$12.46) and, in particular, P\$12.50. Support levels at P\$12.38 and P\$12.20.

Previous recommendation: High probability of reaching levels of P\$12.38 as the first floor and P\$12.20 as the next floor.

3 YEAR M BOND

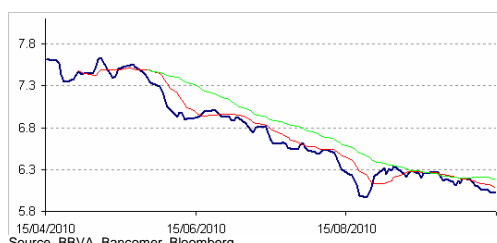


Source, BBVA, Bancomer, Bloomberg

3 YEAR M BOND: (performance): It has not managed to consolidate the bounce back from the previous week, and has returned to levels below the short term moving average. There is renewed risk of falling to 5.10 which would be eliminated by a rebound to above 5.20.

Previous recommendation: This gives a support level of 5.20 and resistance of 5.40.

10 YEAR M BOND



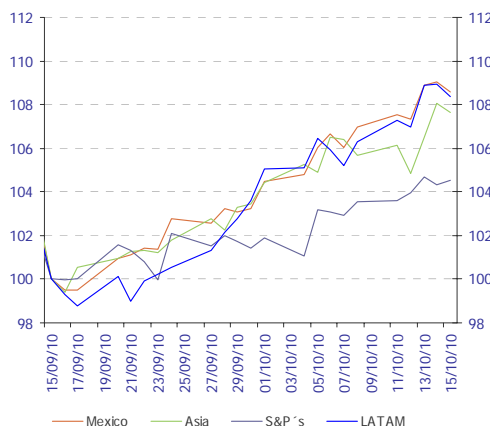
Source, BBVA, Bancomer, Bloomberg
Source: BBVA Research with data from Bloomberg

10 YEAR M BOND (performance): Return to the 6.0 zone. It may begin to register a rebound from a double technical bottoming out, but we need to watch that it does not break through this floor.

Previous recommendation: Remains below the 10 and 30 day moving averages meaning that the trend is still negative and there is a risk of returning to the 6.0 zone.

Markets

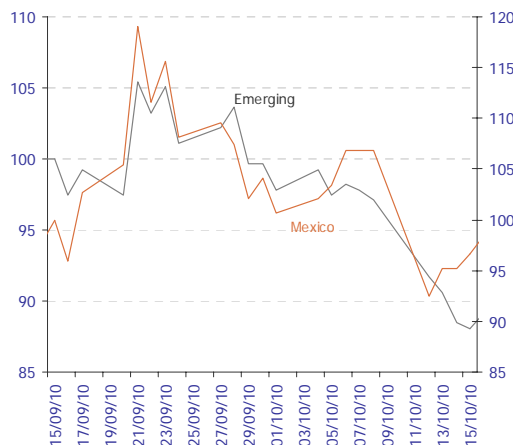
Chart 7
Share Markets: MSCI indexes (index Sep 15, 2010=100)



Source: Bloomberg & BBVA Research

Depreciation of currencies in the region and falls in stock markets at the end of the week due to worse than expected US figures

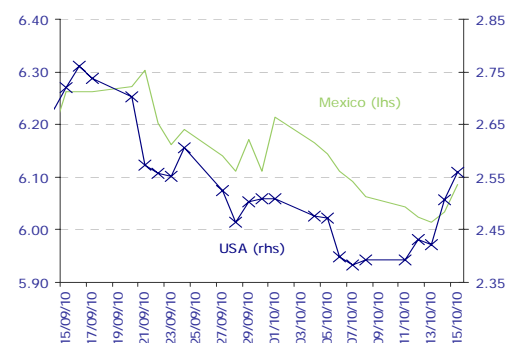
Chart 9
Risk: EMBI+ (index September 15, 2010=100)



Source: Bloomberg and BBVA Research.

Increased risk aversion towards the end of the week.

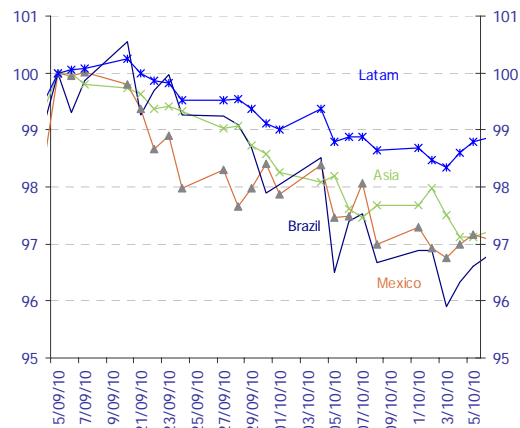
Chart 11
10-year interest rates*, last month



Source: Bloomberg and BBVA Research

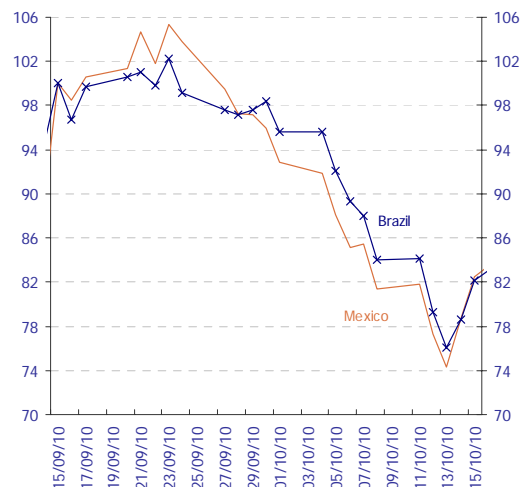
Fall in demand for bonds in the face of lower uncertainty about monetary expansion.

Chart 8
Currencies: Exchange rates against the dollar (index Sep 15, 2010=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 10
Risk: 5-year CDS (index September 15, 2010=100)



Source: Bloomberg and BBVA Research.

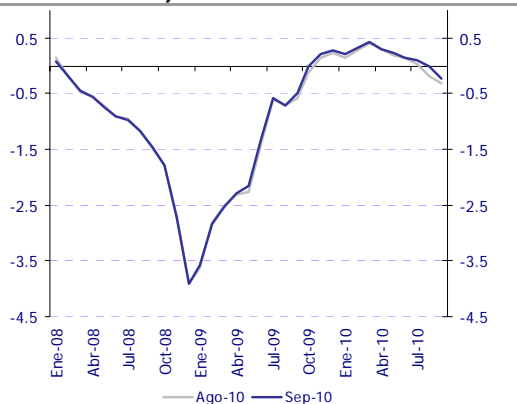
Chart 12
Mexico carry-trade index (%)



Source: Bloomberg and BBVA Research

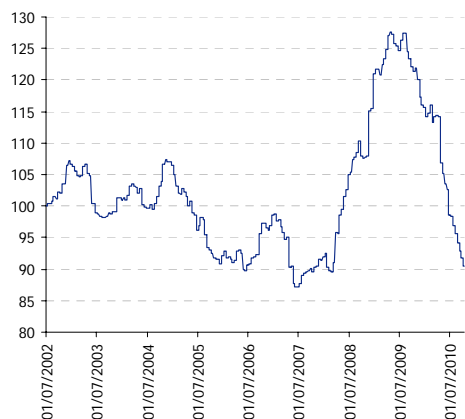
Economic activity, inflation, monetary conditions

Chart 13
**Economic Cycle Indicators
(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
**Inflation Surprise Index
(July 2002=100)**



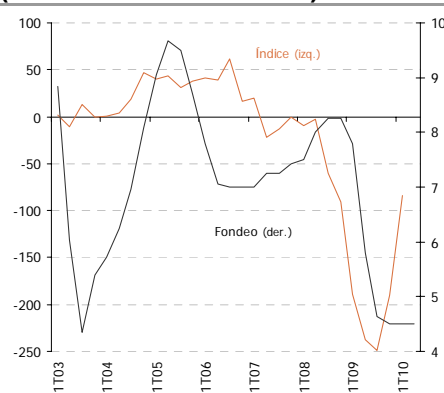
Source: BBVA Research with data from Banxico on the monthly surveys of expectations of private sector economic specialists.

Chart 17
Monetary Conditions Index



Source: BBVA Research

Chart 14
**Indicator of inflationary demand pressures & bank funding rate
(Standardized index & %)**



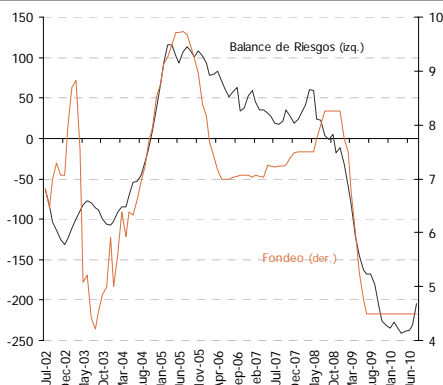
Source: BBVA Research and Banxico

Chart 16
**Activity Surprise Index
(2002=100)**



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

Chart 18
Balance of inflationary risks* and bank funding rate (standardized and %; monthly av.)



Source: BBVA Research. * Standardized and weighted index (of inflation and economic growth) based on 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.

With regard to the consensus, inflation surprises remain downside

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

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