

Mexico

Weekly Watch

January 14, 2011

Next week...

Economic Analysis

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Market Analysis

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...Banxico set to keep lending rate...

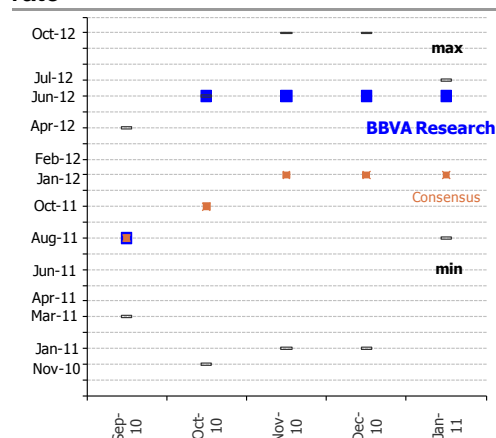
With inflation expected to remain in the range forecast by Banxico and growth that slowly closes the negative output gap, it is reasonable to assume that the Bank of Mexico will maintain the lending rate for a further month, at 4.5% since July 2009. Maintaining this scenario of moderate growth and inflation below 4% in coming quarters reinforces the outlook of a prolonged monetary pause beyond 2011. The Banxico statement will maintain the outlook of moderate growth in the U.S. that is wary of global financial markets with abundant liquidity generated by expansionary monetary policies in developed countries, and therefore the search for profitability, and in turn the search for lower risk facing the uncertainty regarding the resolution of the public debt turmoil in some euro area countries. In the domestic environment, we expect Banxico to continue to signal the outlook of slower growth and controlled inflation in an environment with a lack of demand pressures and an exchange rate that is strengthening. However, we must be attentive to the messages from the monetary authority regarding the recent rise in food commodity prices in international markets, amplified by the repeated mention that the issue has had in recent press. *[continued on next page]*

The curve incorporates new monetary policy expectations, the peso has strengthened and the launching of corporate reports in the U.S. between the facts and relevant dynamic

Balance sheet of U.S. economic data still favorable and season of positive reports contributed to strengthen the MXN by 1.7% in a week. With implied currency volatility it stays low and the forward curve points to strengthening, we see a floor at 12.0 and possible rebound to 12.15. In turn, the fixed income market began to incorporate a tightening cycle by the end of Q2-11; however, current economic conditions continue to point to a monetary pause throughout 2011. In the week, the reporting season of S&P 500 companies could include a utility increase of 31% according to the consensus

Chart 1

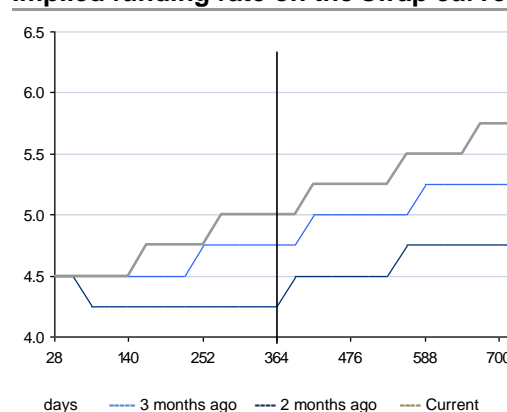
Movement expectations in the lending rate



Source: BBVA Research with Banamex data

Chart 2

Implied funding rate on the swap curve (%)



Source: BBVA Research with data from Bloomberg

Economic Analysis

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Calendar: Indicators

Banxico, decision on monetary policy

Friday, January 21. Decision: maintain (4.5%); Consensus: maintain

(continued from previous page)

Inflation in Mexico and commodity prices in the international market: limited relationship

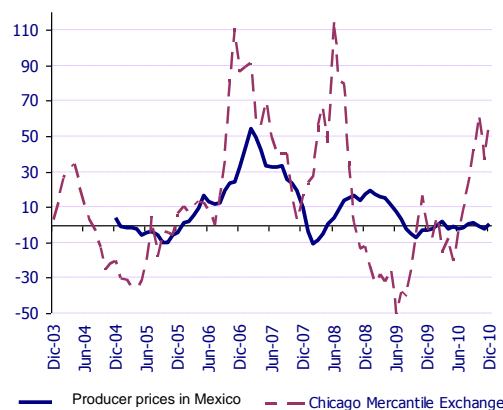
Analysts and international agencies have pointed out that the recent upturn in food commodity prices is a significant upward risk to inflation and downward for economic recovery in emerging markets. In the case of Mexico, it is observed that, until now, the transfer of price increases in international food markets to the domestic ones is still very limited. Among other reasons, this is because i) different domestic food producers do not move their prices in line with international prices due to a market structure that hinders access to export markets, and ii) the proportion of imports in the consumption of some of the foods with most weight in the CPI basket of goods, wheat, corn and sugar, is low. Furthermore, international prices of food at this time are still somewhat lower than the peaks in 2008 and 2009, depending on the product. With moderate growth in the U.S. and Europe, and as uncertainty is reduced concerning sovereign risk of the peripheral countries of the Euro, it is expected that prices of food and other commodities will be reduced. However, it is necessary to monitor its progress, and in particular keep track of news on agricultural crops, energy prices, and pricing decisions of domestic producers who do not export.

Unemployment rate in December

Friday, January 21: 5.2% CSV Consensus: N/A November: 5.4

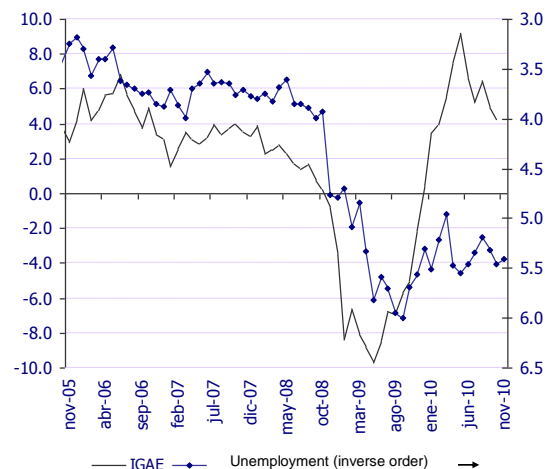
Given the dynamics of recent months, it probable that the unemployment rate on the active population has continued to oscillate in the 5.0% -5.5% range which it has been moving in throughout 2010. This is a comparatively high figure for the performance of the activity. The lack of agreement in economic recovery with a decrease in the unemployment rate may be related to the concentration of employment recovery in relatively few activities intensive in capital use, such as the manufacturing sector.

Chart 3
Price of maize (Var% yoy)



Source: BBVA Research, Bank of Mexico

Chart 4
Economic activity and unemployment rate
(yoy % and % in EAP)



Source: BBVA Research and INEGI

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Markets

The market has changed its monetary policy expectations in recent months

In early October, the market had delayed the start of the monetary cycle of rising rates. Later, with the expectation of less dynamic growth, the Swap curve incorporated a drop in rates over the next six months. Now, with the upward pressure that has been observed recently, the market features a restrictive cycle for the end of the second quarter 2011, as well as the normalization amount: 125bp upward (cumulative) in fees for the next two years vs. 25 and 75 bp that the curve subtracted 2 and 3 months ago respectively. This increase may be adding to the upward pressure that has been observed in the markets due to risk aversion and increased international liquidity. Given current economic conditions, we estimate a monetary pause during 2011.

Strengthening of 1.7% for moderation of risk premiums: psychological support of 12.0, without ruling out a correction towards the area of 12.15

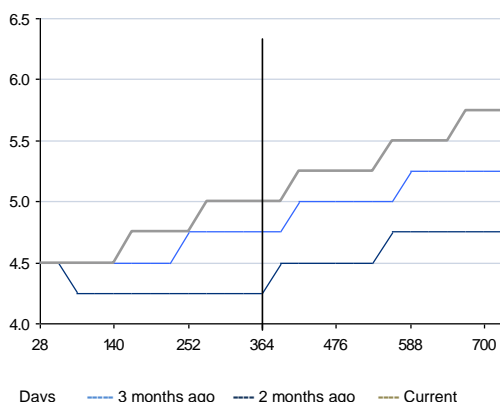
Last week the MXN posted a strengthening of 1.7% in response to a moderation in global risk premiums and a continuation of favorable expectations for the global cycle. Specifically, there are three main elements that act in favor of the currency: 1) U.S. economic data, to which the Mexican peso has shown a greater degree of sensitivity (although mixed results, the end inflation data and industrial output favored a further shift towards the area of 12.08), 2) favorable corporate earnings reports in the U.S. and 3) lower risk of intervention in the currency market by Banxico (in contrast with the position of most countries in the region). Additionally, implied volatility is still going down, the *forward* curve continues to reflect an expectation of strengthening and the long MXN speculative position in the CME increased by U.S. \$405mn. However, the level of 12.0 is a psychological level of support, so do not rule out a further correction towards the area of 12.15.

Reporting results season, the consensus estimates a utility increase of 31% for the S&P 500 companies.

To date, only 7 companies have reported, with a 31.4% growth in EPS and exceeding market expectations by 12.5%. The three positive reports from Alcoa, Intel and JPM stood out the previous week, particularly the second one with a positive outlook for 2011. This week activity will increase: 49 reports are expected, which include Apple, Citigroup, IBM, WD, BoNY, EBAY, GS, State St, WF, AMD, Freeport, Google, MS, BofA and GE. While the trend of positive surprises has been decelerating in recent quarters relative to the September 2009 peak (79.5%), it is noteworthy that the estimates for 2010 have not changed significantly over the last three months, leaving room to exceed expectations and, therefore, with the capacity to act, at least, as a support for the stock exchanges. In turn, the earnings season in Mexico will begin by next week.

Chart 5

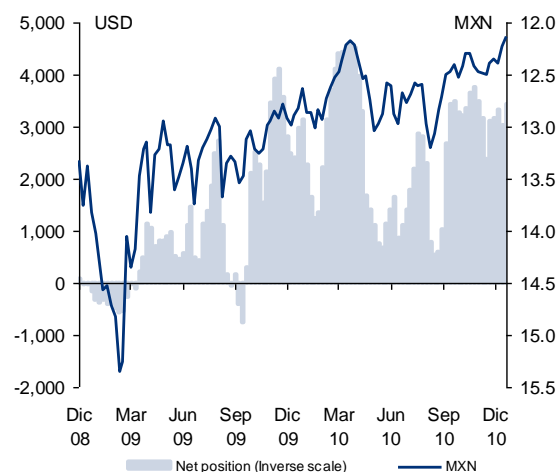
Implied funding rate on the swap curve (%)



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

Mexico City, January 14, 2011

Market Analysis
Variable Income**Technical Analysis****Alejandro Fuentes Pérez (*)**
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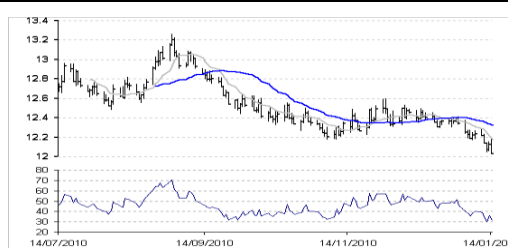
(*) Writer(s) of the report

Technical Analysis**CPI Stock Market Index**

Source: BBVA, Bancomer, Bloomberg

CPI The CPI adjustment during the first two weeks of the year (-1.3%) means that the market has returned to levels of short term support by trading around the moving average 30 days (38.106 pts) at the end of the week. We believe that this level may be observed due to strong sales of several of the issuers of the CPI which can begin to cause technical rebounds on them. It is important that the following sessions are capable of being placed above 38.106 pts to reduce short-term pressure. This rebound approach would only be eliminated with a CPI movement towards 37.721 pts, which would confirm a breakthrough of the 30-day moving average with more than 1%.

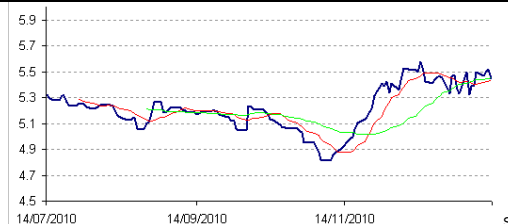
Previous Record: A downward breakthrough of the latter would set a reverse in the short-term trend. Resistance is maintained at 39.000 and 39.500 points.

MXN

Source: BBVA, Bancomer, Bloomberg

MXN: During the week the dollar drops to below the minimum area of last year by being placed under P \$12.16, and the moving average of 200 weeks that is placed at P\$12.11. As a result, it only has the psychological level of P\$12.00, and it has not operated under this amount since October 2008. We could see technical rebounds, although it would only change trend above P\$12.32.

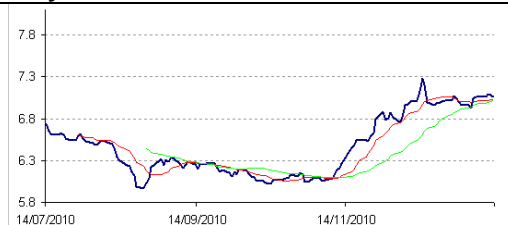
Previous Record: We believe that this could show a short-term rebound to levels between the 10-day and 30-day rolling averages, between P\$12.29 and P\$12.35.

3-year M BOND

Source: BBVA, Bancomer, Bloomberg

3-YEAR M BOND (performance): Remains at the same levels of the previous week. It still respects the 10 and 30 day moving averages and maintains levels of support at 5.3% and resistance at 5.6%.

Previous Record: Support at 5.3%, initial resistance at 5.6% and then at 5.8%.

10-year M BOND

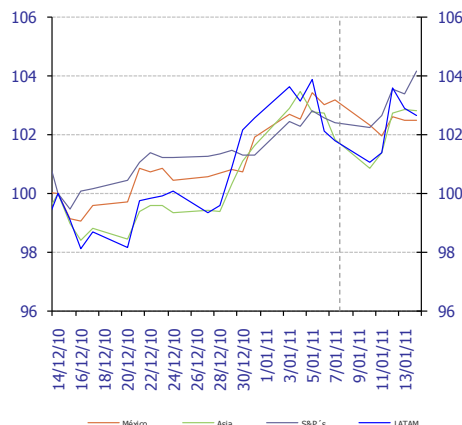
Source: BBVA, Bancomer, Bloomberg

10 YEAR M BOND: (performance): Continues to operate slightly above rolling averages of 10 and 30 days. We do not change support and resistance levels.

Previous Record: Support at 6.9% and resistance at 7.3%.

Markets

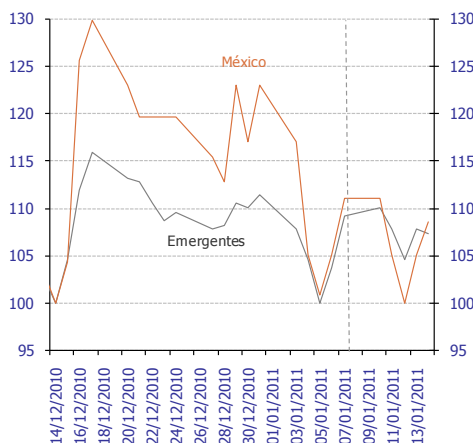
Chart 5
Stock markets: MSCI indices (December 14, 2010 index = 100)



Source: Bloomberg & BBVA Research

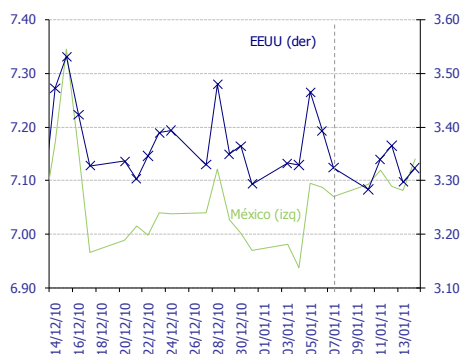
Data of initial unemployment claims better than expected in the U.S. reverses trend of rising markets. Higher than expected industrial output data supports strengthening of the peso and separates it from the region

Chart 7
Risk: EMBI+ (December 14, 2010 index = 100)



Source: Bloomberg and BBVA Research.

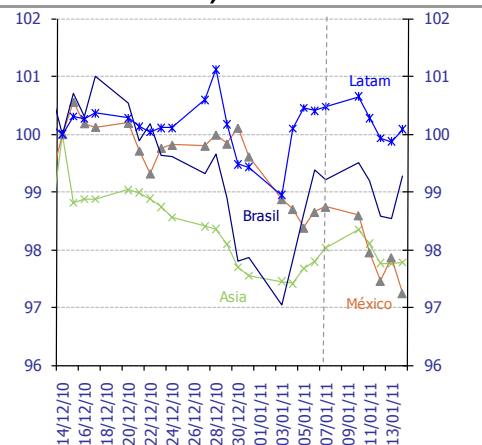
Chart 9
10-year interest rates*, last month



Source: Bloomberg and BBVA Research

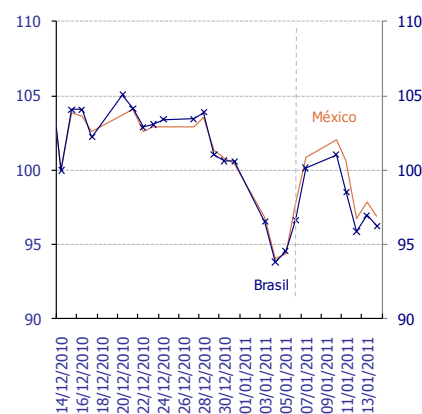
Rate hikes towards the end of the week due to an increase in expectations of U.S. growth. Movements of the week influenced by FED auctions and purchases. Rates in Mexico move in line

Chart 6
Currencies: rates against the dollar (Dec 14, 2010 index = 100)



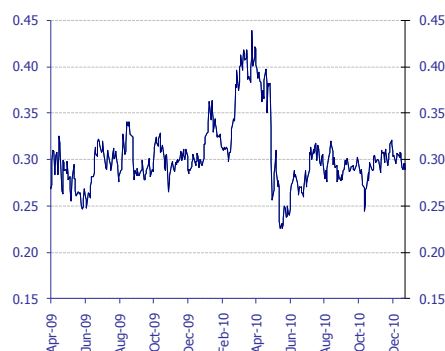
Source: Bloomberg and BBVA Research. Note: LATAM includes Argentina, Brazil, Chile, Colombia and Peru. Asia includes the Philippines, South Korea, Taiwan, Singapore, Indonesia and Thailand. Non-weighted averages.

Chart 8
Risk: 5-year CDS (Dec 14 index=100)



Source: Bloomberg and BBVA Research.

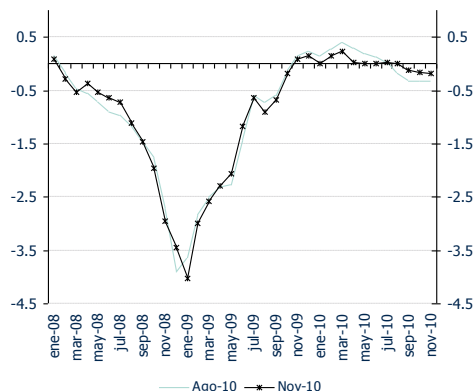
Chart 10
Carry-trade Mexico index (%)



Source: Bloomberg and BBVA Research

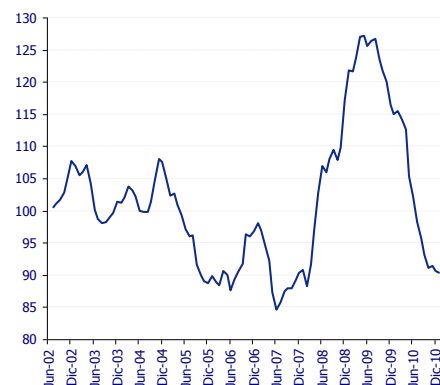
Activity, inflation, monetary conditions

Chart 11
**Economic Cycle Indicator
(Standardized)**



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

Chart 13
**Inflation Surprises Index
(July 2002=100)**



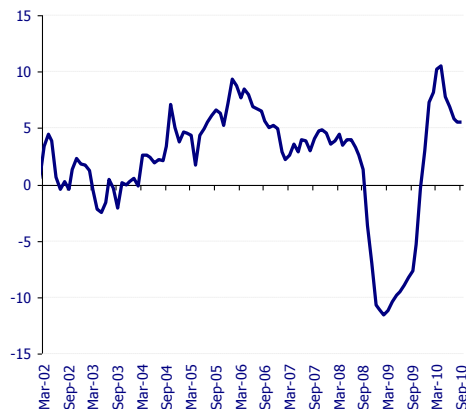
Source: BBVA Research with data from Banxico from the monthly surveys on the expectations of economic specialists in the private sector.

Chart 15
Monetary Conditions Index



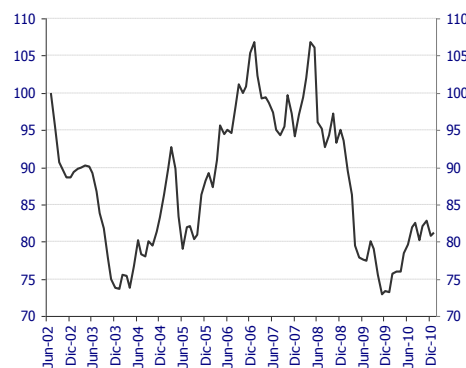
Source: BBVA Research

Chart 12
**Advance Indicator of Activity
(% y/y change)**



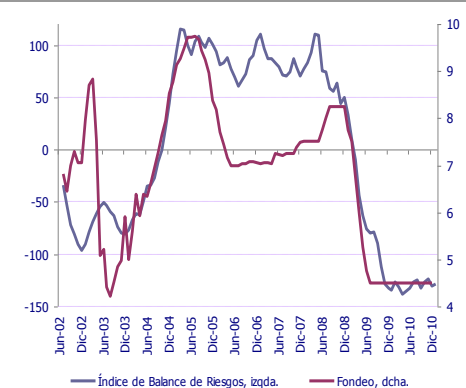
Source: INEGI

Chart 14
**Activity Surprise Index
(2002=100)**



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

Chart 16
**Balance of Inflationary Risks* and
Funding (standardized and %; monthly averages)**



Source: BBVA Research. *Standardized, weighted index (between inflation and economic growth); uses economic indicators for activity and inflation. A rise in the IBR signals greater weight of inflationary risks over those of growth and, therefore, more likelihood of monetary restriction

Economic activity in Mexico has improved, but the speed of recovery appears to have moderated

Inflation surprises went down most of 2010, while activity surprises were moderate

The monetary conditions in which the economy is moving are accommodative. No upward movements are therefore expected to the reference rate in the short term

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