Mexico

Weekly Watch

January 21, 2011

Economic Analysis

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Market Analysis

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Next week…

Inflation in the first half of January with updated CPI:

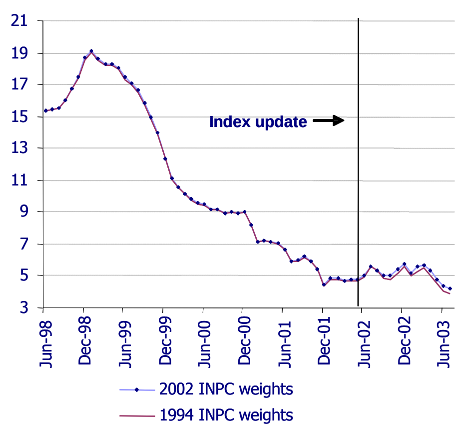
Monday's publication of the inflation figure for the first half of January will feature an updated CPI basket of goods and services. This process will be carried out on a regular basis so that the measurement of inflation may be based on a CPI basket that represents as precisely as possible the structure of consumer spending, which is made public by the INEGI National Survey of Household Income and Spending (ENIGH). Current CPI component factors are based on the survey carried out in 2000 and were updated for 2002 prices, year when the CPI base was changed. For this new update, the factors will be based on ENIGH 2008 and will be updated for 2010 prices, with a base date of the new CPI in the first two weeks of December 2010. We believe that the CPI update will not imply significant changes in observed inflation and that possible bias in the future will be minimal, as was the case in the previous update and is shown in Chart 1. Furthermore, the central bank will take the opportunity of the CPI update to update as well the Core and Non-core sub-indices by way of reclassifying some products and services, among which telephony which is transferred from Non-core to Core as it is considered that its prices are not limited existing regulation in the sector.

The monetary pause will continue but the policy announcement includes more restrictive biases that have entailed corrections in the MXN (Mexican peso), the loss of correlation with the US bond market, and slumps in the stock market index

With regards to currency, the possibility of increasing Banxico dollar sales becomes less likely after the monetary policy announcement and as regards technical factors there are indications of lateral dynamics with positive bias during the week. As concerned fixed income, the theme relevant to the market is the remaining time before the restrictive cycle is started. Therefore, as we consider an increase of funding this half of the year very unlikely, the medium and long part of the curve should ease over coming weeks, when the stability of the Treasury Notes will be a determining factor.

Chart 1

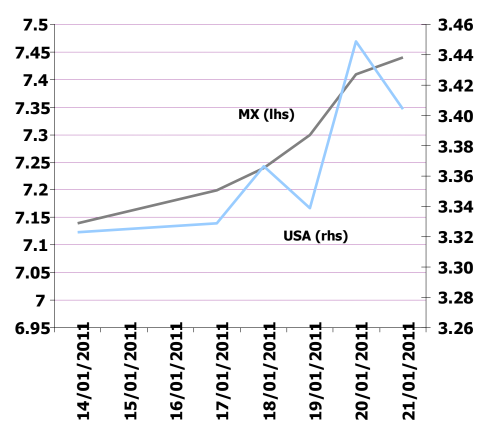
Inflation with CPI base 2002 and simulation with 1994 factors (Variation y/y, %)



Source: BBVA Research with Banxico data

Chart 2

10-year interest rates (%)



Source: BBVA Research with data from Bloomberg

Economic Analysis

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Calendar: Indicators

January Q1 inflation:

Monday, January 24: CPI 0.3% q/q (4.1% yoy) Consensus: 0.32% q/q (previous:4.4%)

We expect that during January 1Q price rose due as much to seasonal factors as to the update of some controlled prices. The core index will continue to be subject to pressures in the area of processed foods but due to the positive evolution of the rest of the components it comprises, we estimate that it will rise 0.27% during the two-week period. On a yearly basis, the trend in inflation will be downward during the first quarter of 2011 as a result of the statistical effect caused by inflationary increases back in the first quarter of 2010 derived from the tax increase, the deregulation of controlled prices, and an unfavorable backdrop in the agricultural sector. Although the extent of this inflation slump could be limited by the possible impact of price rises in commodities, we believe that a large part of these shocks will be of transitory nature and that they should not have significant effects on inflation forecasts. This is in line with that stated by Banxinco in its monetary policy statement, in which it emphasizes that both the base effect as well as exchange appreciation compensate, in part, the rise in the worldwide prices of some products.

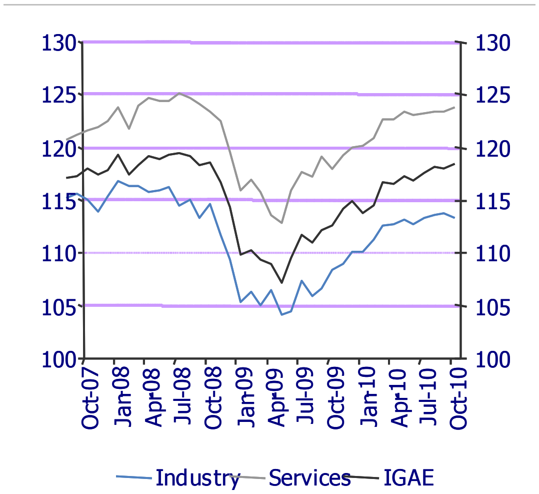
IGAE (Economic Activity Index) in November

Thursday, 27 0.4% m/m 4.2% y/y CSV, 3.2% Not CSV. Consensus: 2.5% Not CSV November: 0.5% m/m CSV (previous: 0.5%, 5.2% y/y)

This week sees the publication of the evolution of economic activity in the next-to-last month of last year. We believe that, together with the already known moderate rebound in industrial production (0.21% m/m), the services component will tend to rebound as well. Nevertheless it should be noted that two factors may create a downward bias for the closing of last year's activity. On the one hand, the diverging trends of foreign and domestic demand, made manifest for instance by the evolution of manufacturing branches with a clearer link to the internal cycle, growing at rates close to 2% y/y compared to those sectors more linked to exports, whose growth is nearing 10%. Also, although the trend in private formal employment is highly satisfactory–sustainably growing at 0.5% m/m–it is also important to note that wages are limited by falling real wages compared to last year.

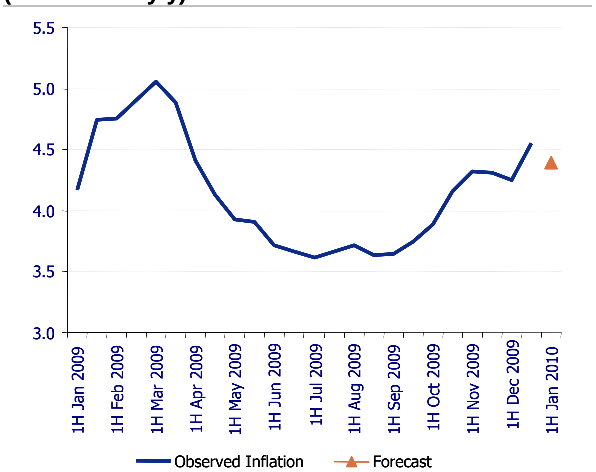
In any case, activity is coming close to redressing the drastic fall experienced during the 2009 recession. We believe that the Economic Activity Index (IGAE) will grow by 0.4%, which would imply an annual rate of 4.2%, 1.3 percentage points less than the average between July and October.

Chart 3
IGAE Economic Activity Index (Index 2003=100)



Source: BBVA Research and Banxico

Chart 4
First quarter inflation observed and forecast, January
(% variation y/y)



Source: BBVA Research and Banxico

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Markets

Loss of correlation of domestic rates with US Treasury Bills due to monetary and technical factors

The technical positioning of the medium and long-term is extremely weak. The trajectory of the local 10-year bill is open for levels of 7.5%. Two factors explain this *negative* momentum: 1) lack of desirability associated to the losses seen over recent months, a factor worsened by the recent evolution of commodities and the risks involved; and 2) the Banxico statement suggests that margin is being created for its decision to withdraw the monetary stimulus in the future–but this communication strategy occurs in an atmosphere of uncertainty regarding the inflationary effect of commodities and of more solid economic growth than had been expected–which is steepening the yield curve again.

The question to be asking is how long until the restrictive cycle is initiated. The probability that it will be initiated in the first half of 2011 is extremely low, while it is now more likely to occur in the fourth quarter. The slope of the curve (1A/10A) indicates that the restrictive cycle will be started within two or three months, which is not viable. The medium and long parts should relent over the next weeks, with the stability of Treasury Notes a determining factor. In the medium term, the market will position itself in keeping with the Banxico rise, with pressured slopes four to five months before the restrictive cycle and a slowing rate in the three months preceding it (with an upward change in level).

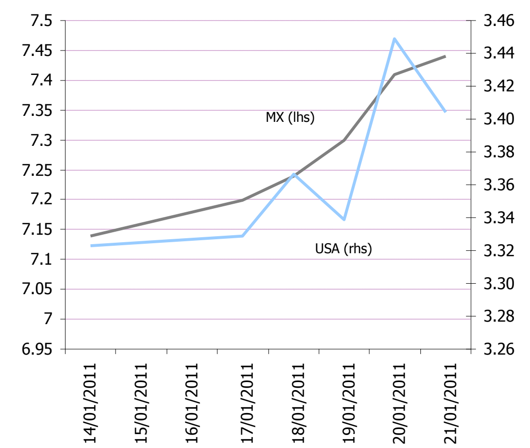
Positive bias for MXN upon showing sensitivity to US cycle. The monetary policy statement undermines the probability that the amount of dollar options will be increased.

During the week, the combined reduction of risk premiums in Europe and positive economic data from the US helped create greater demand for emerging currencies, in spite of the poor performance of the stock markets. With this situation worldwide, the MXN continues to display increased sensitivity to the US economic cycle, which is why the positive bias is sustained. The aforementioned trend could be accentuated this week due to the greater number of reports from the US expected to be positive. Also, recent speculation over the possibility that Banxico would make more month's end put options available was put to an end with its statement on monetary policy on Friday, which made reference to the effect of the increase of the exchange rate on inflation. In all, and considering technical factors, for this week we maintain expectations of sideways movement with a positive bias, in an estimated range of 11.90–12.10.

As in Latin American as a whole, the Mexican stock market experienced a volatility surge and reacted negatively after the monetary policy announcement.

In an atmosphere where US business results became less important, the stock markets of Brazil and Mexico were affected by the monetary policy statements (Wednesday and Friday, respectively). In the case of Mexico, the more restrictive language in the monetary statement implied an increase in the probability of a rise in the policy rate and losses in the stock market index. This boost will be transitory and the US economic cycle and sovereign risk speculation will soon play a greater role.

Chart 5
10-year interest rates (%)



Source: BBVA Research with data from Bloomberg

Chart 6
VIX vs. MXN implied volatility

Source: BBVA Research with data from Bloomberg

Mexico City, January 14, 2011

Market Analysis

Equities

Technical Analysis

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Technical Analysis

CPI

Source: BBVA, Bancomer, Bloomberg

CPI: During the week we could see how the Mexican market reduced this technical level by over 1% and, simultaneously, the latter reached a level under the 50-day rolling average. On the other hand, the 10-day rolling average has changed its trend and passed below the 30-day rolling average. These factors suggest that the adjustment of the market may extend into the future and that the CPI will reach new minimum levels, which we expect to be 37.000pts, 36.500pts y 36.000pts. An important floor is reached with the last of these, constituting a pushback of 61.8% according to the Fibonacci model.

Previous record: The rebound expectation would only be eliminated with a CPI movement towards 37.721 pts, which would confirm a breakthrough of the 30-day rolling average with more than 1%.

MXN

Source: BBVA, Bancomer, Bloomberg

MXN: Although the peso momentarily passed below the reference level of P$12.00, it bounced back to above this level by week's end. Short-term oscillating indicators, as well as the moving averages spread over 10 and 30 days, suggest a technical rebound with resistance in P$12.10 and P$12.25.

Previous record: We could witness technical rebounds, although the tendency would change only if this was above PS$12.32.

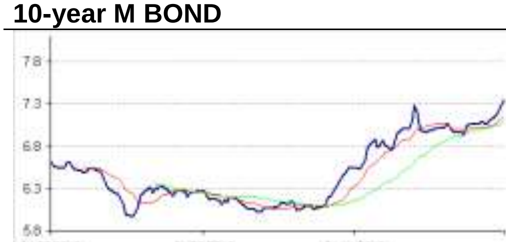
3-year M BOND

Source: BBVA, Bancomer, Bloomberg

3-year M BOND: (yield): After reaching a floor on 10-day and 30-day rolling averages, it rebounded above the resistance by 5.6%, with the resistance being the zone between 6% and 6.2% with high levels of short-term overbuying.

Previous record: It still respects the 10 and 30 day moving averages and maintains levels of support at 5.3% and resistance at 5.6%.

10-year M BOND



Source: BBVA, Bancomer, Bloomberg

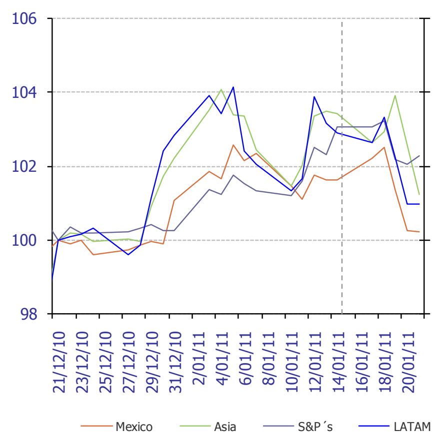
10-year M BOND (yield): Reaches slightly below the resistance at 7.3%, with the following resistances at 7.5% and 7.75%.

Previous Record: We do not change support and resistance levels.

Markets

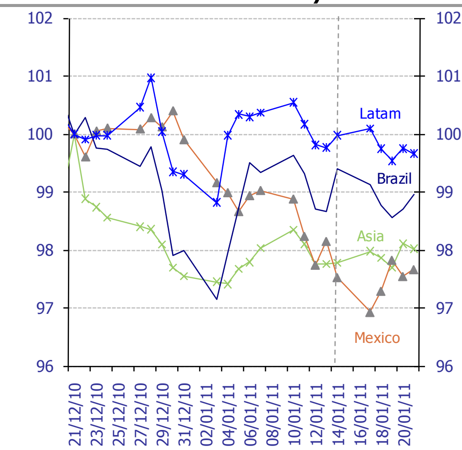
Expectations of interest rates increases in China predominate over better-than-expected economic and business data from the US, and generate stock market losses. Monetary policy decision impacts peso depreciation at week's end

Chart 5
Stock markets: MSCI indices (index 21 December 2010 = 100)



Source: Bloomberg & BBVA Research

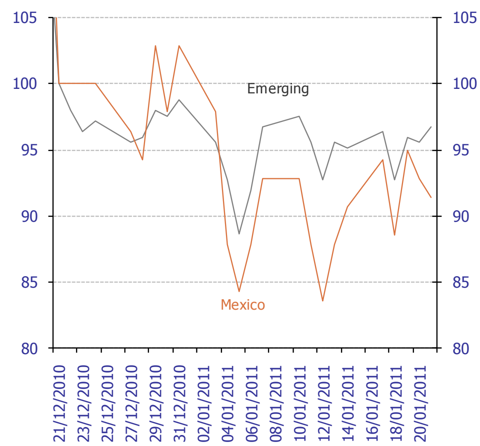
Chart 6
Currencies: rates against the dollar (21 December 2010 index = 100)



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.

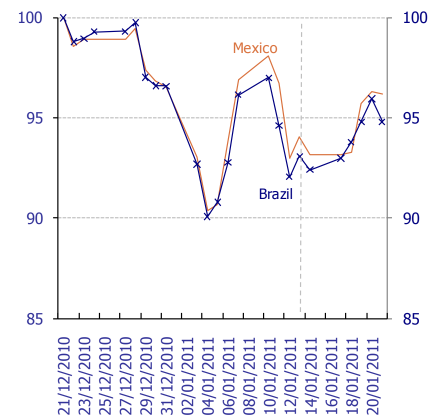
Increase in risk aversion at the end of the week due to preoccupations concerning price rises in China.

Chart 7
Risk: EMBI+ (21 December 2010 index = 100)



Source: Bloomberg and BBVA Research.

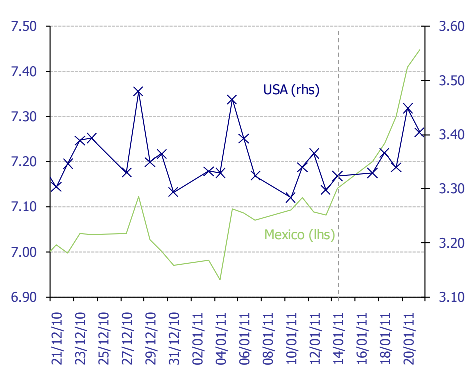
Chart 8
Risk: 5-year CDS (Dec 21 index=100)



Source: Bloomberg and BBVA Research.

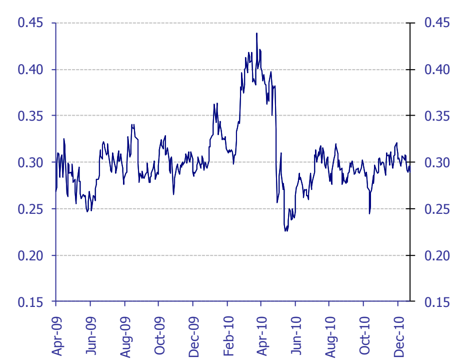
Increase of rates during the week due to positive data in US. Rates in Mexico are dissociated from those of the Treasury. The rising rate is reduced at week's end after decision to maintain the lending rate

Chart 9
10-year interest rates*, last month



Source: Bloomberg and BBVA Research

Chart 10
Carry-trade Mexico index (%)

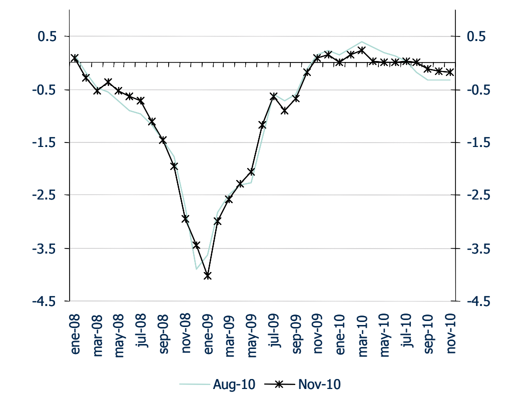


Source: Bloomberg and BBVA Research

Activity, inflation, monetary conditions

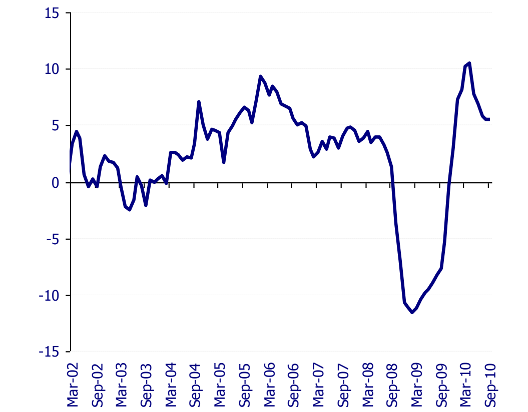
Economic activity in Mexico has improved, but the speed of recovery appears to have moderated

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.

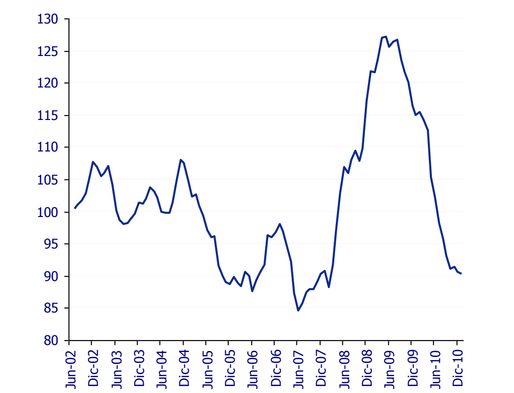
Chart 12
Advance Indicator of Activity (% y/y change)



Source: INEGI

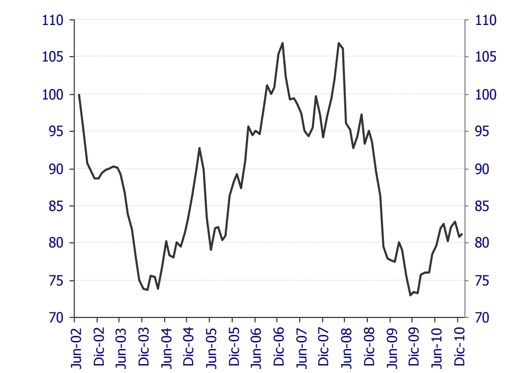
Inflation surprises went down most of 2010, while activity surprises were moderate.

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 14
Activity Surprise Index
(2002=100)



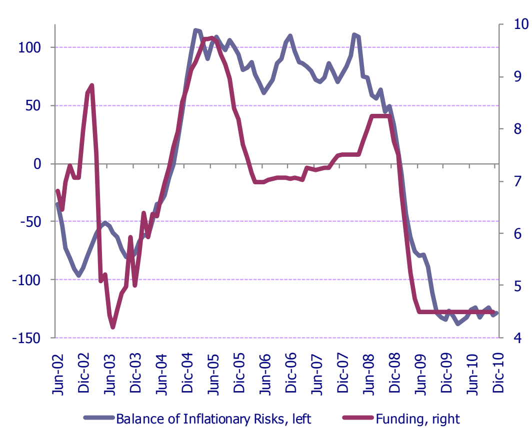
Source: BBVA Research with data from Bloomberg. Difference between recorded data and the Bloomberg consensus for seven activity variables in Mexico. Standardized index. Rises (falls): positive (negative) surprises.

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

Chart 15
Monetary Conditions Index

Source: BBVA Research

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 risk over those of growth and, therefore, more likelihood of monetary restriction

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