

Mexico

Weekly Watch

January 28, 2011

Next week...

Economic Analysis

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Market Analysis

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Banxico starts publishing the minutes of its monetary policy meetings: more information to reinforce communication

The most significant event of the coming week is the publication of the minutes of the Board of Governors of Banxico's monetary policy meeting. This will increase transparency and improve communication with the public, which is essential for achieving inflation objectives. As a result, on 4 February we will find out in greater detail than we would from the previous press release the factors which most influenced the decision of the members of the Board of Governors to hold the bank lending rate at 4.5%. At present we do not know how the minutes will be structured or what they will contain; however, they will be published 10 working days following the announcement of the monetary policy decision, and they may mention the distribution of voting in the decision making, without specifying how the individual members voted. Similar communications by other central banks provide us with some indicators. In the cases of the Bank of England (BoE) and the US Federal Reserve (FED), the minutes provide a review of the current financial and economic situation, both domestically and, in broad-brush terms, internationally. These minutes have few references to specific figures, but there is an evaluation at the start of each paragraph of each of the sectors and aspects analyzed. The minutes then describe the positions of the members of the monetary policy committee, both for the current situation and the economic outlook, subsequently detailing how each member then voted on the monetary policy decisions.

[continued on next page]

Increased holding of Cetes federal government bonds by foreigners and closing of short positions on the peso favored by global risk

During the first two weeks of January, foreign investors continued increasing their holdings of Cetes federal government bonds, taking this to 24% of the total (7% at the start of September last year) seeking out arbitrage opportunities on rates. This is consistent with a bias towards appreciation of the currency which continued throughout the week to Thursday, 27. On Friday the currency depreciated by 1.2% against the dollar despite the good US growth figures as a result of the closing of positions before the end of the month, and because of perceptions of increased global risk because of events in Egypt.

Chart 3
Monetary Policy Calendar 2011

	Monetary Policy Meetings	Monetary Policy Minutes	Inflation reports
January	21		
February		4	9
March	4	18	
April	15	29	
May	27		11
June		10	
July	8	22	
August	26		10
September		9	
October	14	28	
November			9
December	2	16	

Source: Banxico

Chart 2
Holding of Cetes bonds by foreign investors
(billion pesos)



Source: BBVA Research with Banxico data

Economic Analysis

Calendar: Indicators

**Banxico minutes[continued]
Friday, February 4**

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The Federal Reserve also details the voting on the text of the minutes released to the public following the meeting. In Latin America, similarly but more concisely, the Bank of Chile places more emphasis on the members' discussion of the domestic and international economic and financial situation, the policy options available and their justification. Unlike the BoE and the FED, only the names of those members who support the majority decision are published, and not those of the members who vote against. Finally, in Brazil, the review of domestic and international economic activity and inflation is based on a huge amount of current data, whilst the monetary policy section describes the position of the committee with regard to this environment. Finally, it gives the overall results of voting, without stating how each member voted.

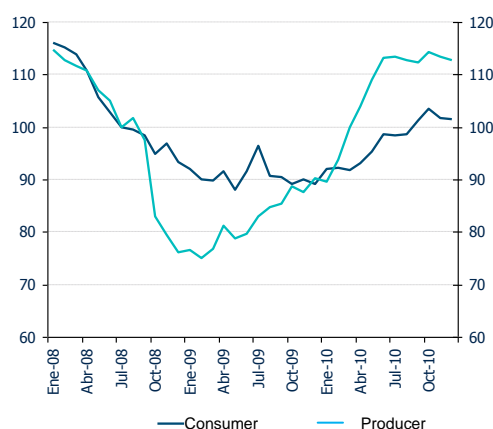
Consumer and producer confidence in January

Producer: Thursday, 3.0% m/m 25.9% y/y SA.

Consumer: Friday 4, -0.7% m/m, 9.5% y/y SA

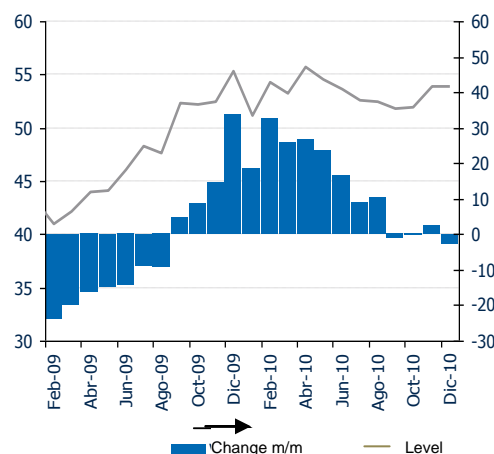
At the end of this week we will receive the first indications of the 2011 outlook for manufacturing producers and consumers. These two indicators of confidence have behaved very differently since the crisis: whilst producer confidence has recovered to pre-recession levels, consumer confidence remains anchored at levels well below those prior to the crisis. Given the recent dynamics in industrial activity in the United States, and based on changes in recent months in the producer confidence index, and sub-indices such as expected orders, it is likely that confidence will have remained flat at the end of the year, and that it will bounce back once there is a clearer and more positive outlook for data such as US payroll or improved US domestic demand. In this context, consumer confidence may contract slightly, as it has over the past two months. Once again, it will play a key role in the performance of employment and household purchasing power, which we expect to improve gradually as inflation converges on the Banxico target.

Chart 3
**Confidence: consumer and producer
(Indices, Jul 08=100)**



Source: BBVA Research and Banxico

Chart 4
**Manufacturing Orders Indicator: Expected volume
of orders
(Level and m/m % change)**



Source: BBVA Research and Banxico

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Markets

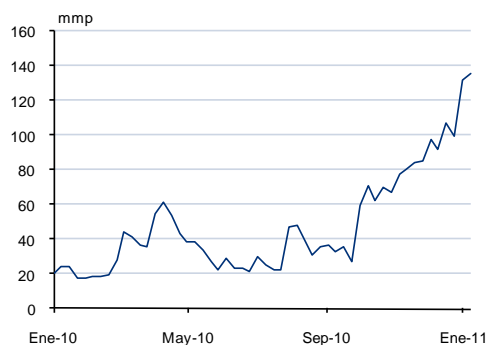
Foreign investors increase their holding of Cetes bonds significantly in search of arbitrage opportunities

The short stretches of the Cetes bond curve are not consistent with the current bank lending rate; this is the result of a strong appetite by foreign investors for arbitrage opportunities which has resulted in the rate on 1 month paper being over 15 bp below the 1 day rate. This distortion of the curve has spread; in other words, the yield on the 1 day instrument is 3 bp above the 3 month yield. This increase in demand is reflected in a significant increase in the holding of Cetes bonds by foreign investors, which had reached 135.4 billion pesos on 13 January, an increase of 283% on holdings at the start of September 2010 –up from 7% of the total to 24%. Having said this, the short stretch of the Cetes bond curve is at over-bought levels; we therefore see little value in this stretch of the curve and continue recommending positions with longer durations.

Closing of short positions in USD in the face of political risks, accentuated by month-end adjustment, resulting in flows to emerging currencies

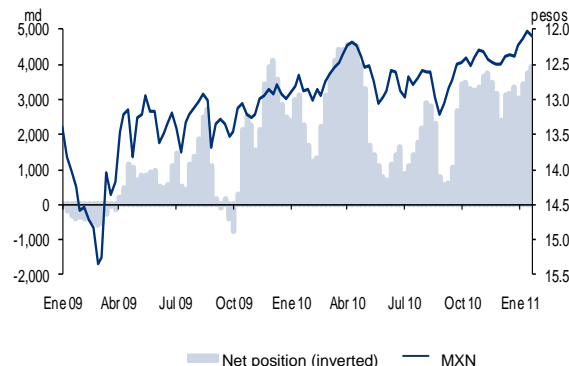
Whilst the peso maintained a positive bias over the last week, the currency closed on Friday with a depreciation of 1.2%, at around 12.20. This occurred despite favorable 4Q10 US growth figures (3.2% quarterly annualized, consensus: 3.5%, BBVA Research: 3.3%) which was an improvement on the previous quarter -2.6%- and represents a solid performance which in principle should have moved us towards the region of 12.02. We see two elements behind this development: 1) end of the month closing of short positions in USD (the net USD short position vs. EUR, JPY, GBP, CAD, AUD CHF and MXN in the CME stood at US\$22.1 bn last Tuesday, whilst the long position on MXN was US\$3.9 bn); and 2) risk aversion in global markets resulting from political tension in Egypt. This movement was also reflected in the implicit volatility of MXN (up 0.70 vegas for 1M), which is in line with the 24% increase in the VIX index. We consider that if this global risk aversion continues, we could see movement towards the region of 12.28. However, we would expect that following the adjustment on Friday, many of the MXN long positions will have been unwound and we would expect a technical adjustment (subject as in recent months to the performance of US share indices and economic data).

Chart 5

Holding of Cetes bonds by foreign investors (billion pesos)

Source: BBVA Research with Banxico data

Chart 6

Peso, non-commercial long position (US mn)

Source: BBVA Research with data from Bloomberg

Mexico City, January 28, 2011

**Market Analysis
Equities****Technical Analysis**

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Technical Analysis**CPI Stock Market Index**

Source: BBVA, Bancomer, Bloomberg

IPC: The IPC index continues to be below its 10, 30 and 50 day moving averages and may continue the adjustment movement to the next support zone, which would place it between 36,500 pts and 35,850 pts. This latter level corresponds to 61.8% under the Fibonacci model, and may represent a significant floor for the market. Even though the negative movement in the USA may have only just begun, the differential between the IPC and the Dow leads us to believe that this floor (2% below the current level) may be respected.

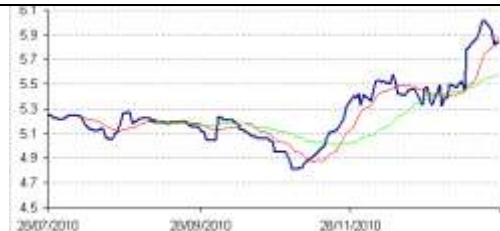
Previous rec: The adjustment of the market may extend into the future and the IPC will reach new floors, which we expect to be 37,000 pts, 36,500 pts and 36,000 pts.

MXN

Source: BBVA Bancomer, Bloomberg

MXN: The currency ended the week with a bounce back which took it above the 10 day moving average until it met with resistance at the 30 day moving average (P\$12.19). We consider that there is still a possibility of an upward breakthrough of this level to a next level at P\$12.40. There are good signals from the oscillating indicators.

Previous Rec: Short-term oscillating indicators, as well as the moving averages of 10 and 30 day spreads, suggest a technical rebound with resistance at P\$12.10 and P\$12.25.

3-YEAR M BOND

Source: BBVA, Bancomer, Bloomberg

3-YEAR BOND: (yield): Reached resistance at 6% and starting an adjustment. The very wide dispersal between the 10 and 30 day moving averages suggests that it may return to the 5.55% zone.

Previous Rec: Resistance in the zone between 6% and 6.2% with high levels of short-term overbuying.

10-YEAR M BOND

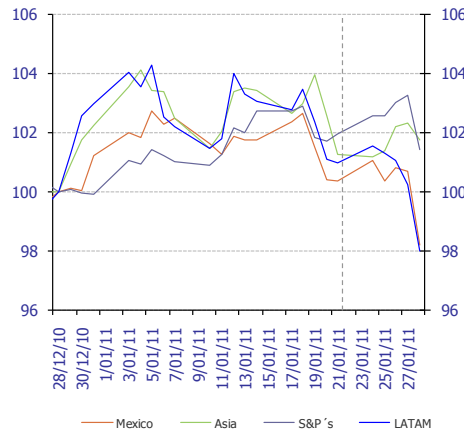
Source: BBVA, Bancomer, Bloomberg

10-YEAR M BOND (yield): Resistance encountered at 7.4% although at the moment we would only consider a return to the support level of 7.1%.

Previous Rec: Next resistances at 7.5% and 7.75%.

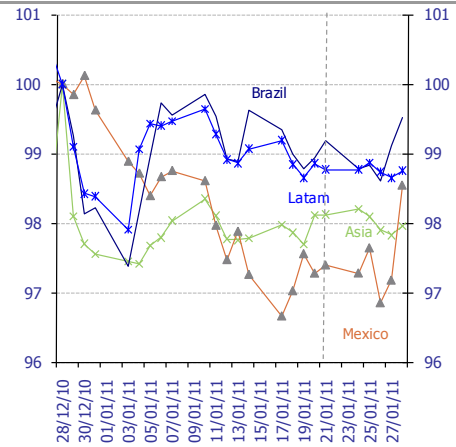
Markets

Chart 5
Stock markets: MSCI indices (December 28, 2010 index = 100)



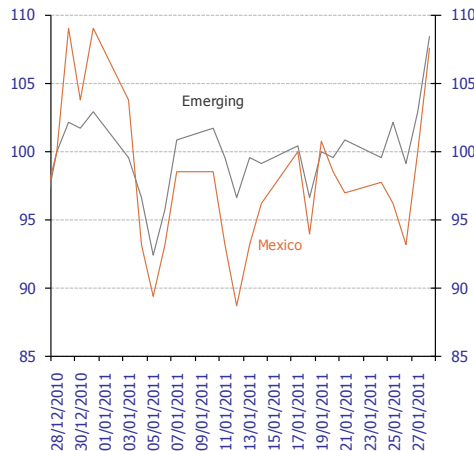
Source: Bloomberg & BBVA Research

Chart 6
Currencies: rates against the dollar (Dec 28, 2010 index = 100)



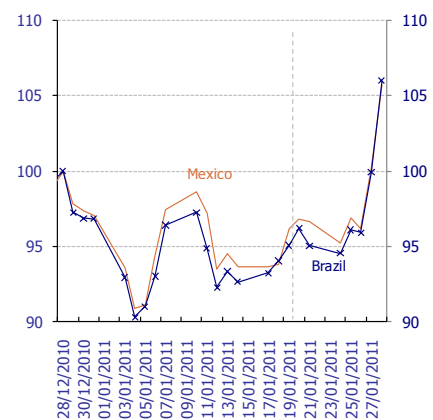
Source: Bloomberg and BBVA Research. Note: LATAM includes Argentina, Brazil, Chile, Colombia and Peru. Asia includes the Philippines, South Korea, Taiwan, Singapore, Indonesia and Thailand. Non-weighted averages.

Chart 7
Risk: EMBI+ (December 28, 2010 index = 100)



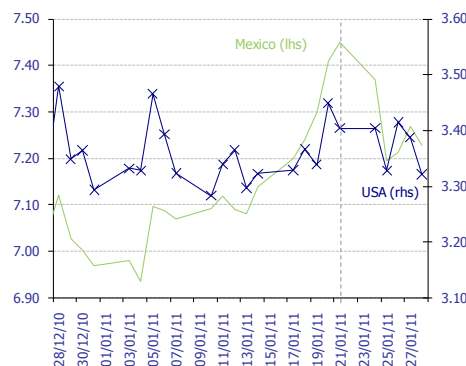
Source: Bloomberg and BBVA Research.

Chart 8
Risk: 5-year CDS (Dec 28 index=100)



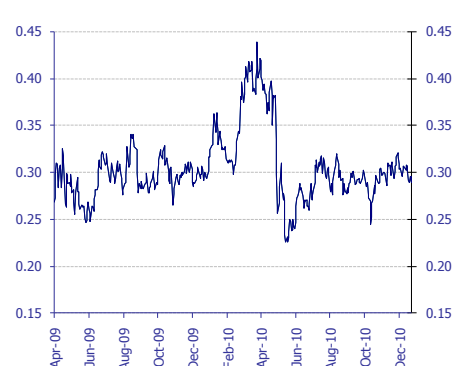
Source: Bloomberg and BBVA Research.

Chart 9
10-year interest rates*, last month



Source: Bloomberg and BBVA Research

Chart 10
Carry-trade Mexico index (%)



Source: Bloomberg and BBVA Research

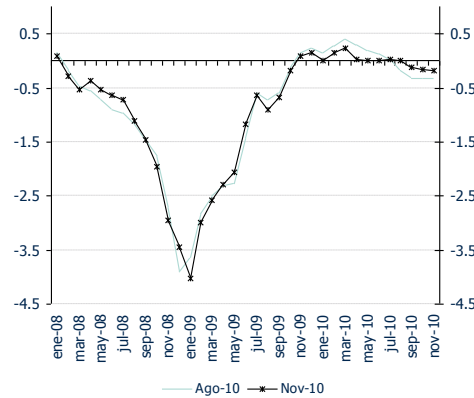
Generalized fall across stock markets and peso depreciation towards the end of the week, despite good US GDP growth figures for 4Q10, because of increased perception of global risks.

Increase in risk aversion at the end of the week due to increased geopolitical risk

Fall in US rates as a result of flight to quality. Rates in Mexico are falling influenced by US rates and despite the depreciation of the peso

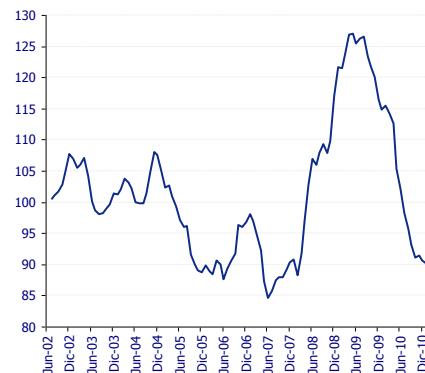
Activity, inflation, monetary conditions

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



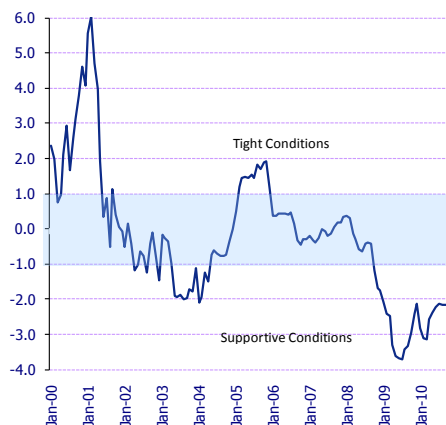
Source: BBVA Research with data from INEGI, AMIA and BEA. Weighted sum of 21 different activity indicators, expenditure and expectations, based on trend series.

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



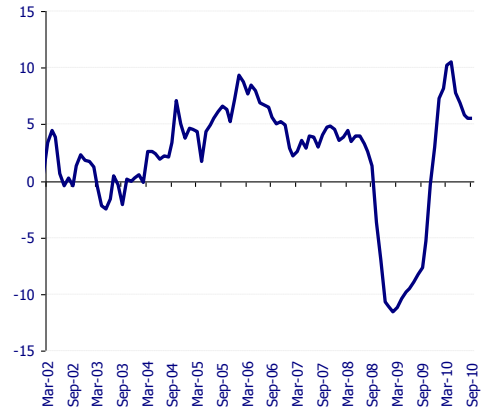
Source: BBVA Research with data from Banxico from the monthly surveys on the expectations of economic specialists in the private sector.

Chart 15
Monetary Conditions Index



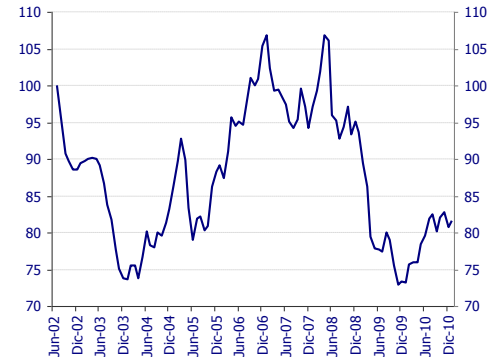
Source: BBVA Research

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



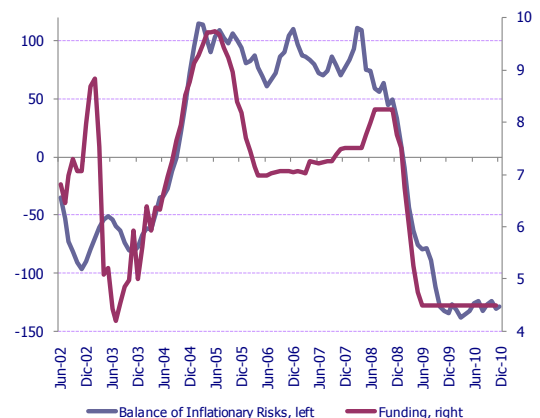
Source: INEGI

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 pace of recovery appears to have slowed

Inflation surprises decreased throughout most of 2010, while activity surprises moderated.

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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