BBVA Research

Mexico

Weekly Watch

February 4, 2011

Economic Analysis

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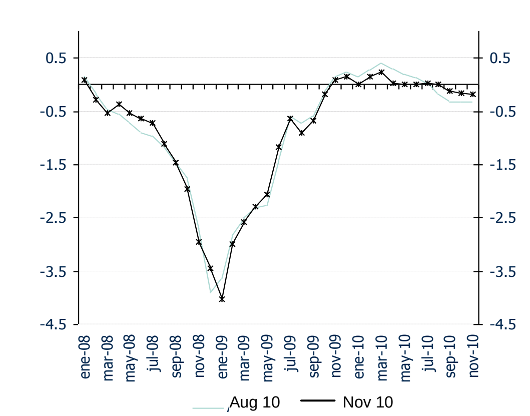
Next week…

Indicators of economic activity and prices will show moderate growth, with increasing contribution from domestic demand and lower inflation.

The coming week sees the publication of indicators relating to the close of last year: December industrial production and the National Survey of Occupancy and Employment (ENOE) for 4Q10 on the activity side; as well as the January inflation data and the Banxico report on inflation for the last quarter of last year, which is relevant for analysis of monetary policy. The minutes issued today, Friday the 4th, from the January meeting showed common elements in their structure to those of other central banks in developed countries. We consider that they clearly express They stress that inflationary expectations are a very important component of Banxico decision-making. Banxico highlights that the output gap is only one of the indicators taken into account in deciding-making, and that the rise in commodity prices is not a concern, as it does not affect inflationary expectations. There is no mention of replacing convergence towards the target inflation of 3% at the end of 2011 with "… convergence of inflation to its permanent target of 3 percent".

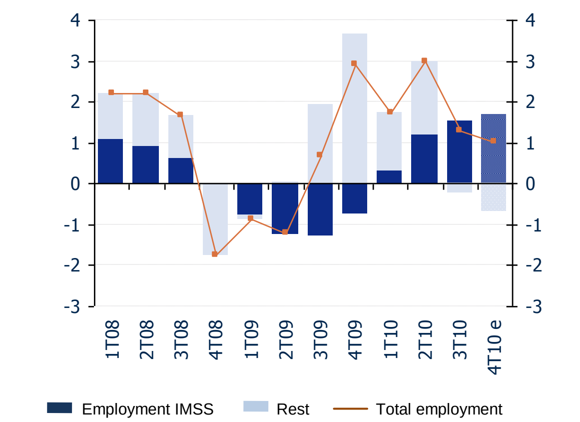
The information available so far suggests that at the end of 2010 the Mexican economy tended to stabilize its monthly growth. There was even a slight recovery by the components lagging behind most in the cycle, such as services and construction, in contrast with the sectors that were initially more dynamic, such as manufacturing industry. Average growth in the last two months of 2010 was 0.3% in the Economic Activity Index (IGAE) for services and (-)0.1% for industrial output. Both imports of capital goods, which are linked to investment, and imports of intermediate goods, linked to industrial output, tended to moderate towards the end of the year. A key factor in the domestic sector was the increase in employment, with stable rates of around 0.5% m/m. This is all consistent with the recovery being underway, although at a slower rate than in mid-2010. It is highly likely that Mexican GDP in 2010 will have grown slightly above 5%.

Chart 3
BBVA Synthetic Activity Indicator of activity for the Mexican economy



Source: Banxico

Chart 2
Employment (y/y % change)



Source: BBVA Research with Banxico data

Economic Analysis

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Calendar: Indicators

Inflation

Friday, February 4

Friday 0.55% m/m (3.84% y/y); (previous: 0.5% m/m, 4.4% y/y)

The January inflation figures will be released on Wednesday. We expect a monthly increase of 0.55%, boosted mainly by the increase in the core component, which will grow by around 0.48% m/m. The main factor pushing core inflation up will be food prices, boosted by the higher price of cigarettes resulting from increased IEPS tax, and of tortillas, though these have slowed in recent fortnights. Non-core inflation will increase by 0.75%, boosted by energy prices and government-regulated tariffs. However, they will increase less than in January 2010, when there were major rises in tariffs such as the Metro of Mexico City. Annual inflation has begun to fall steeply. This is mainly due to the comparison base with 2010, when VAT increased from 15% to 16% and various public prices were unfrozen. We expect this trend to be maintained at least for the first quarter.

December Industrial Production Indicator

Friday, February 11: 0.3% m/m (3.4% y/y SA), (previous: 0.2% m/m, 4.2% y/y SA)

Given the recent movements in indicators such as U.S. industrial output, we expect that Mexican industrial output will have continued to grow moderately in December, slightly above the figure for the previous month. Sectors that had presented the biggest lag, such as construction, or branches of industry that are more linked to the domestic cycle, will show a slightly better recovery in monthly terms than those more closely linked to foreign demand.

Structural indicators of occupancy and employment, 4Q10 (ENOE); formal private employment, January 2011

ENOE: Friday 11

IMSS employment: this week, 0.4% m/m (5.3% y/y, SA) (previous: 0.5% m/m, 5.3% y/y, SA)

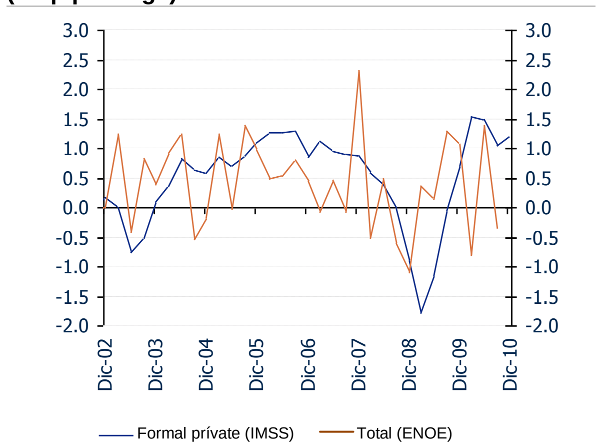
The figures for formal private employment (around a third of total employment) suggest that it will have continued to grow strongly in January. Of note are activities such as construction and manufacturing industry (0.8% m/m in each case, compared with an average of 0.7% and 0.5% respectively in the six previous months). As a result, around 748,000 net new jobs will have been created in the formal private sector of the economy since the same month the previous year. On Friday figures for the performance of the whole labor market will be released. In terms of employment this is more erratic, as can be seen in the accompanying chart, with the effect of an informal component which accumulates more volatile activities and occupations and which functions to a certain extent as a factor compensating movements in the formal market. In addition, although we already know the unemployment rates at the close of last year (5.3% with non-seasonally adjusted figures, 5.5% seasonally adjusted), it will be important to analyze the active population (PEA) and the structure by income, activity, type of economic unit, etc.

Table 1
Estimated inflation by component (% y/y and m/m change)

	Weight	Monthly change (%)				Annual change (%)		
	(%)	Average 2003-2009	Nov-10	Dic-10	Jan-11	Nov-10	Dic-10	Jan-11
CPI-Mx	**100.0**	**0.48**	**0.80**	**0.50**	**0.55**	**4.32**	**4.40**	**3.84**
Core-Mx	*74.8*	*0.40*	*0.25*	*0.47*	*0.48*	*3.63*	*3.61*	*3.43*
Goods	37.0	0.41	0.35	0.48	0.90	3.69	3.82	3.76
Food products	14.7	0.73	0.54	1.08	1.85	3.80	4.35	4.96
Other Goods	22.4	0.17	0.19	-0.02	0.18	3.59	3.37	2.85
Services	37.7	0.39	0.16	0.47	0.15	3.58	3.41	3.17
Rent	17.9	0.19	0.13	0.17	0.25	2.75	2.64	2.36
Education	5.2	0.01	0.00	0.00	0.24	4.65	4.64	4.55
Other serv.	14.7	0.78	0.28	1.00	0.02	4.07	3.76	3.52
Non Core-Mx	*25.2*	*0.70*	*2.31*	*0.55*	*0.75*	*6.20*	*6.60*	*5.01*
Farm products	8.1	1.53	1.38	1.41	0.18	5.59	6.96	4.50
Fruits//Vegetables	3.3	2.00	3.08	2.64	-0.42	10.15	14.00	7.93
Meat//Eggs	4.8	1.28	0.23	0.55	0.64	2.64	2.46	2.24
Public managed	17.2	0.30	2.80	0.11	1.08	6.52	6.41	5.30
Energy	7.8	0.49	5.50	0.25	0.98	6.67	6.44	6.19
Controled prices	9.4	0.09	0.03	-0.04	1.16	6.37	6.37	4.35
					Monthly Revision			*Monthly Revision*

Source: BBVA Research and Banxico

Chart 4
Employment (% q/q change)



Source: BBVA Research and Banxico

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Markets

Closing of short positions in USD in the face of political risks, accentuated by month-end adjustment. This has been transferred to emerging currencies

Last week was laden with economic information and events that impacted the region's currencies. The flow of U.S. economic data (personal spending, the ISM manufacturing index and the unemployment rate) resulted in a positive bias in the majority of crosses, though this was limited by the geopolitical conflicts in the Middle East. In addition, a less hawkish statement than expected by the ECB, coupled with the downgrade in Ireland's debt rating and the statement by Angela Merkel on the purchase of bonds from the European Stabilization Fund, led to profit-taking in EUR trading, which had only marginal and temporary effects on the MXN. Various factors have favored an extension in the trend towards appreciation: 1) Banxico's options had not been exercised at the close of Thursday (there was also a notable bid-to-cover ratio of 5.09 in the end-of-month auction); 2) the implied volatility corrected the rise in the previous month, and closed under 10%; 3) technical oscillating indicators point to a lower risk of correction; and 4) lower risk of exchange-rate intervention by Banxico. The risk to this outlook lies mainly in the Egypt factor, which would result in a consolidation under 12.10.

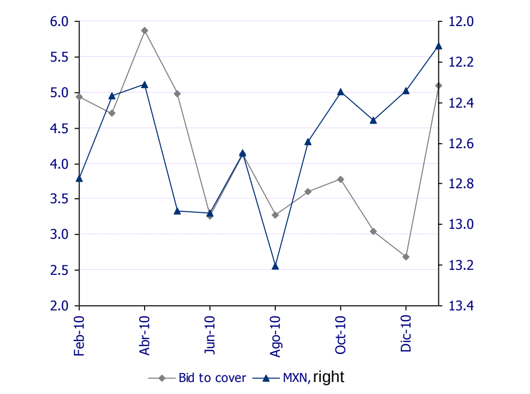
Lower risk aversion leads to a bias for the sale of sovereign bonds

An environment with favorable economic data in the U.S. leads to stronger economic growth. This has led investors to reduce their demand for safe-haven assets and liquidate their positions in Treasuries (e.g. the 10-years registered a correction of 30 bps last week). Given the high rate of correlation between Mexican and U.S. government bonds (3 months: 0.87), this effect is transferred to the domestic debt market, where the 10-year yield increased by around 25 bps. The behavior of the local debt market will be determined by the movement of Treasuries.

A weak start to the reporting season in Mexico will not mark the trend.

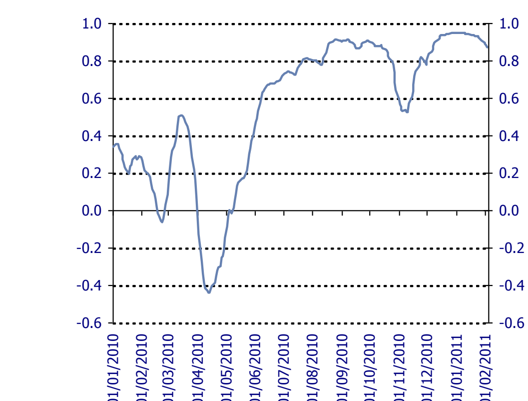
So far only 6 companies listed on the IPC index have reported, with the overall trend weak due to the bad results of Cemex and Telmex. Reporting companies showed a growth in sales from 7.7% to 12.3% in EBITDA and a fall of 31.6% in net profits. However, we believe that this trend will be reversed with the rest of the reports, as we expect them to maintain the trends observed in recent quarters, and despite the comparison base, the mining and industrial sector will continue to give good results. As an aggregate, we estimate growth rates of between 9% and 10% in revenues, EBITDA and Net Profit. There will be little activity during this week in terms of reports, as we only expect that of Amx.

Chart 5
Premium paid on Banxico options vs. MXN



Source: BBVA Research with Banxico data

Chart 6
3-month correlation: Treasury and 10-year bond



Source: BBVA Research with data from Bloomberg

Mexico City, February 4, 2011

Market Analysis

Equities

Technical Analysis

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Technical Analysis

CPI Stock Market Index

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ource: BBVA, Bancomer, Bloomberg

CPI: The upturn of just over 1,300 points in the first three sessions of the week moved the CPI index back to the 30-day moving average (around 38,000 points), after which it adjusted by around 400 points at the close of the week. At this time, this upturn can only be considered a pull-back to a resistance level. Only until it is exceeded can we consider a change in the short-term trend with a new target of 39,000 points. A return by the IPC to below the 10-day moving average (37,488 points) would put renewed pressure on the market over the coming days.

Previous recommendation: The differential between the CPI and the Dow leads us to believe that this floor (2% below the current level) may be respected.

MXN

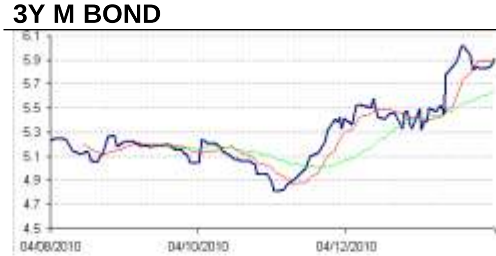
Source: BBVA, Bancomer, Bloomberg

MXN: After unsuccessfully trying to break through the ceiling of the 30-day moving average, it has moved back down towards the MXN 12.00 zone, and has even traded at under this zone. Its trading range in the following days may be between MXN 11.95 and MXN 12.05 (10-day moving average), without ruling out a breakthrough below the support to the MXN 11.75 zone.

Previous recommendation: We consider that there is still a possibility of an upward breakthrough of this level to the next level at MXN 12.40.

Source: BBVA, Bancomer, Bloomberg

3Y M BOND



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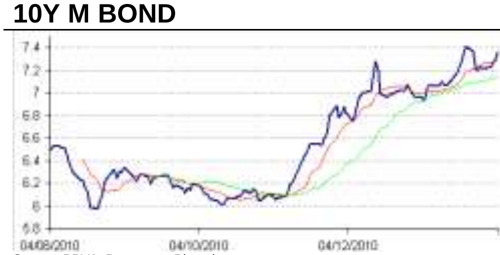
ource: BBVA, Bancomer, Bloomberg

3Y M BOND: (yield): A week of rises, but maintaining the major expansion of moving averages. We believe that the upturn may end at the earlier maximum 6%, with support at 5.7%.

Previous recommendation: The very wide dispersal between the 10 and 30-day moving averages suggests that it may return to the 5.55% zone.

10Y M BOND



Source: BBVA, Bancomer, Bloomberg

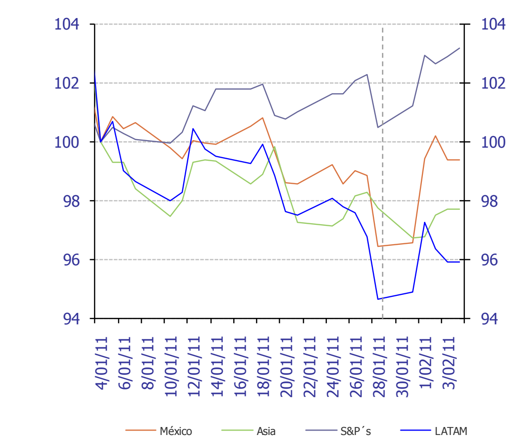
10Y M BOND (yield): Upturn in the week toward the previous maximum of 7.4%. We see a possible return to 7.1% before the upward resistance is broken.

Previous recommendation: At this moment we only consider a return to the support of 7.1%.

Markets

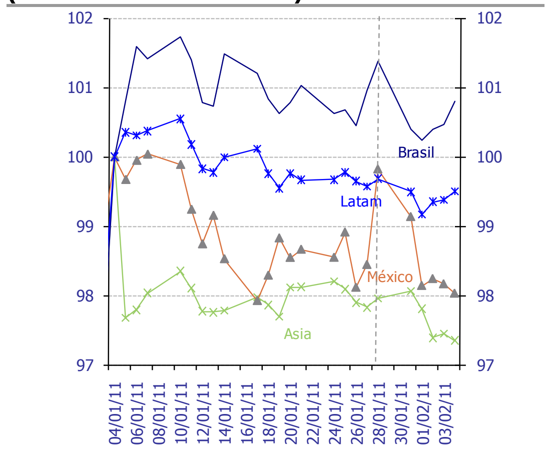
Overall rise in stock markets and appreciation in the peso, linked to a fall in geopolitical risk and better than expected figures from manufacturing industry in the U.S. and China

Chart 5
Stock markets: MSCI indices (Jan 4 2011 index = 100)



Source: Bloomberg & BBVA Research

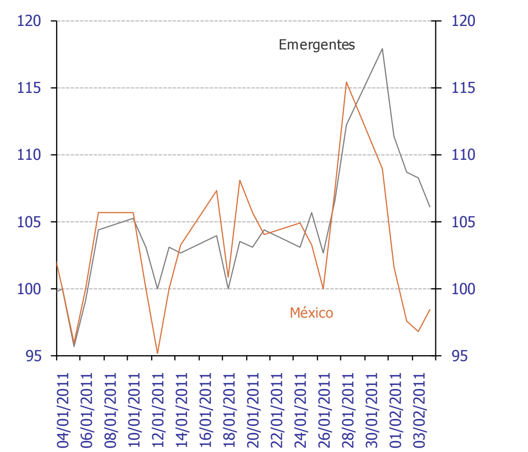
Chart 6
Foreign exchange: Dollar Exchange Rates (Jan 4 2011 index =100)



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.

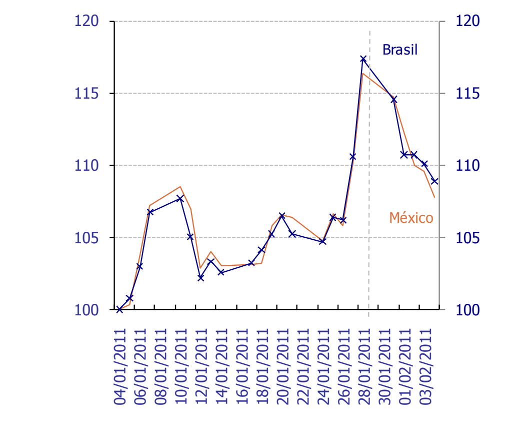
Fall in risk aversion at the end of the week due to a reduction in geopolitical risk

Chart 7
Risk: EMBI+ (January 4, 2011 index = 100)



Source: Bloomberg and BBVA Research.

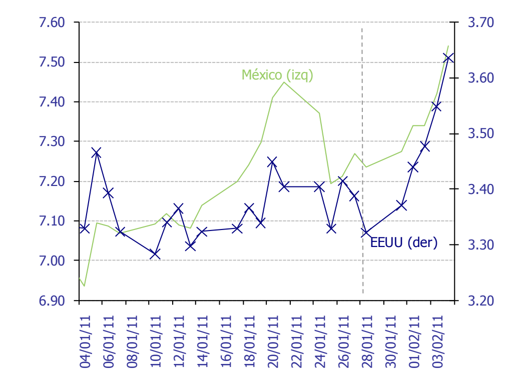
Chart 8
Risk: 5-year CDS (January 4 2011 index =100)



Source: Bloomberg and BBVA Research.

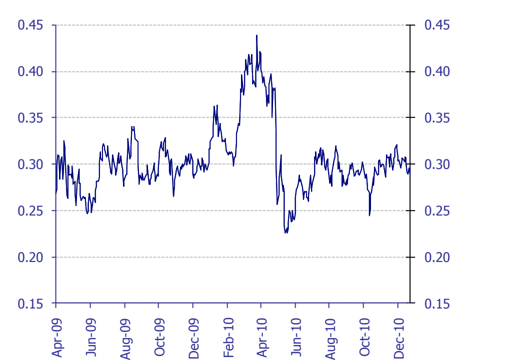
Rise in U.S. rates following data that strengthen the hypothesis of economic growth. Rates in Mexico move in line

Chart 9
10-year interest rates*, last month



Source: Bloomberg and BBVA Research

Chart 10
Carry-trade Mexico index (%)

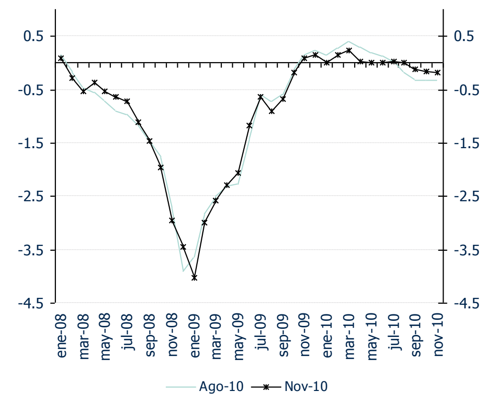


Source: Bloomberg and BBVA Research

Economic activity, inflation, monetary conditions

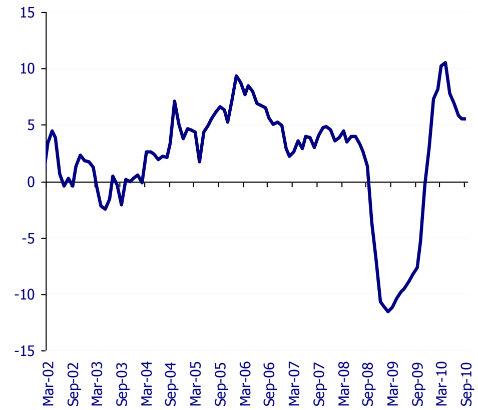
Economic activity in Mexico has improved, but the speed of recovery appears to have moderated

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.

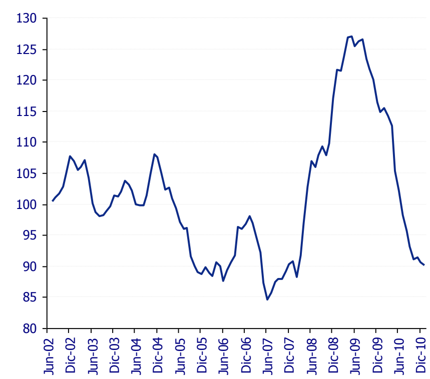
Chart 12
Advance Indicator of Activity (% y/y change)



Source: INEGI

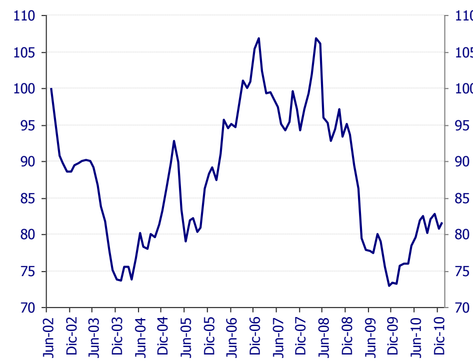
Inflation surprises decreased throughout most of 2010, while activity surprises moderated.

Chart 13
Inflation Surprise 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.

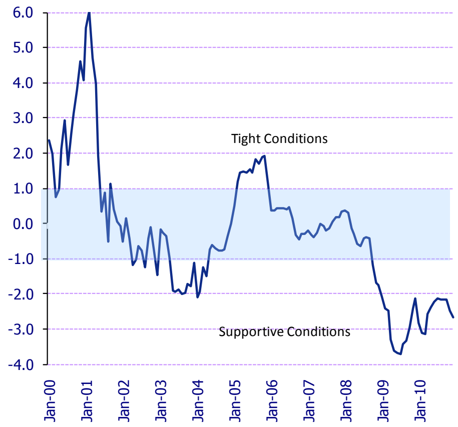
Chart 14
Activity Surprise Index
(2002=100)



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.

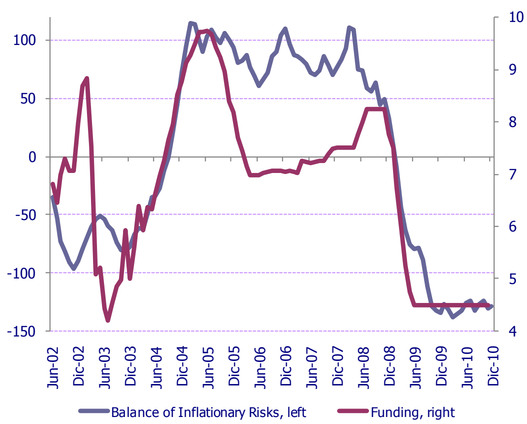
The monetary conditions in which the economy is moving are accommodative. No upward movements are therefore expected to the reference rate in the short term

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

IMPORTANT DISCLOSURES

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