BBVA Research

Mexico

Weekly Watch

March 18, 2011

Economic Analysis

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Market Analysis

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Next week…

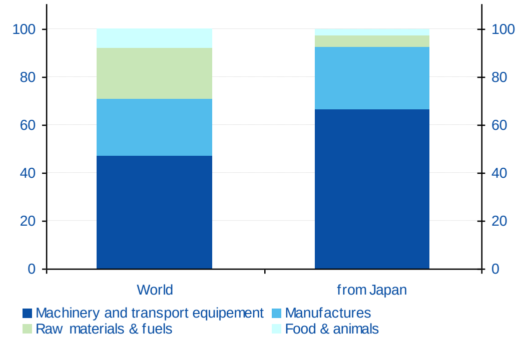
... and the following, the consequences of the earthquake in Japan will continue to affect the economic scenario. Mexico and Japan have a relevant relationship in the automotive sector

The loss of human lives and the pain resulting from the earthquake on the 11th of this month in Japan is inestimable. The destruction of wealth, above all by the subsequent tsunami, is high, close to 3% of GDP according to early estimates. For its part, impact on activity seems moderate at this point, a few decimals down for 2011 and set to rise again in 2012 due to reconstruction work against a backdrop of disappearing nuclear radiation risk and reconstruction of the energy supply. The impact of all of the above on a global scale will be felt by the Mexican economy, which to boot has a relevant economic relationship with Japan. Imports from Japan amount to 5.5% of the total, around 1.3% of GDP (for exports, the numbers are lower), under 1% and 0.2% respectively) and direct foreign investment by Japanese companies in Mexico was 1% of the total. Still, Japan has a key role in industries such as spare parts and high tech companies and a relevant role in some states such as Aguascalientes, Nuevo León, Baja California, and Chihuahua. Therefore there is a risk to consider with regard to the possibility of problems in the production chains of these sectors derived from a lack of supplies, and it will be necessary to pay close attention to developments over the coming weeks.

The uncertainty triggered by international events (MENA and Japan) widens fluctuation ranges in the currency and bond markets.

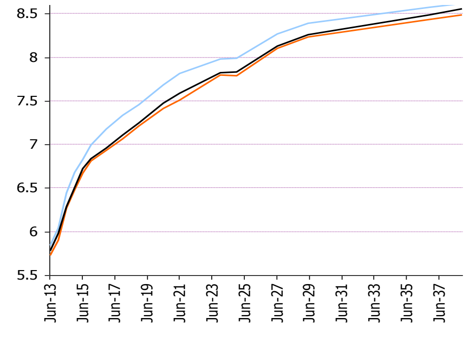
In the bond market, 10-year profitability corrected in less than 10 days almost all of the 40 pbs seen in February and the beginning of March. Its performance hovered around 7.5% (from 7.8%), very close to its support level of 7.45% We believe that cyclical factors will regain relevance and therefore do not rule out the possibility that bond prices will again drop in the coming weeks. In the currencies market, fluctuations of the peso increased (11.895–12.20) with a relative strengthening at the close of the week after the introduction of funds to avoid an excessive appreciation of the JPY resulting from expectations of capital repatriation. Still, the panorama is not totally cleared, and so we do not rule out new episodes of high volatility.

Chart 1
Mexico: goods import by good type (percentage structure)



Source: BBVA Research

Chart 2
Bond yield Curve (%)



Source: BBVA Research

Economic Analysis

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Calendar: Indicators

Inflation Fist two-weeks of March

Thursday, March 24

0.21% over two weeks (3.26% y/y); Consensus: 0.24% over two weeks, Previous: (0.38% m/m 3.57% y/y Feb)

Inflation at the start of the year fluctuated very close to expectations, with important reductions in annual terms in the first months. Still, various factors increased uncertainty with regard to the fluctuation of inflation for the rest of the year, such as the frosts that affected crops in the north of the country and the increase of the price of the tortilla helped by the boost in international grain prices. We therefore consider that March and April will me critical months to determine if inflation will reach a value within the fluctuation range of the central bank (3% with a range of 1%) during summer. We expect that the price of the tortilla will be the main boost to core inflation in the first two weeks of March, with a rise of 0.23% over the previous two-weeks. The prices of Other Services could also be under pressure given the closeness of the Holy Week holiday period. We expect non-core inflation to experience pressures in the area of agricultural and fishing prices, both as a result of the frosts and of the increase in grain prices. However, the effect of the climatic phenomena has been limited up to now. Considering all these factors, year-on-year inflation will continue to fall in March, and there will be an upturn from the second quarter, which should be limited if further risks do not come to pass.

GDP Mexico 1Q10, components of demand

Tuesday March 22, 2009

Forecast 1.1% cont. Domestic demand

Given the fluctuation of GDP over the last quarter of the year (1.3% q/q, 4.4% y/y) it is worth specifying the fluctuation of the components on the spending side. Available data indicate that foreign demand will have continued to be the main support for growth with an acceleration of export rates in particular in the hand manufacturing sectors, with more imports in intermediate goods (consumables). For their part, indicators linked to internal demand such as retail and automobile sales seem to indicate that although private consumption will have continued to grow it will have done so at a slower pace than during the third trimester of the year.

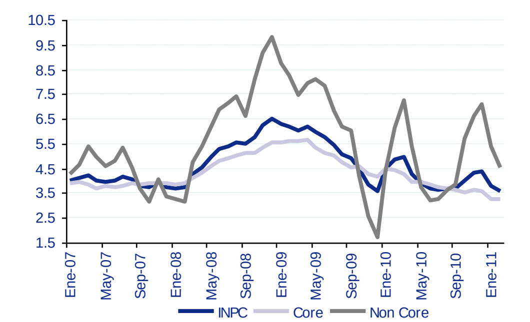
Trade Balance

Friday, March 25

Forecast (761 million dollars) previous (69 million dollars)

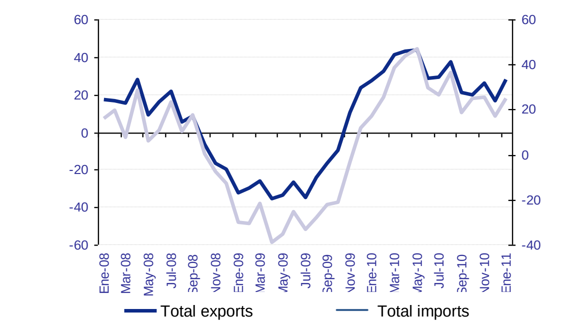
Industrial production in Mexico began this year with a rapid acceleration (1.4% m/m January), this together with the increase in oil prices lead us to expect that in February the trade balance will result in an important surplus. Both exports and imports will show high growth rates around 24% and 23% respectively. The commercial balance will continue to benefit from the more dynamic reactivation of external demand but only proportionally to the continued advance of the recovery domestic demand, and if the appreciation of the peso continues, the balance will become progressively negative, without negatively affecting the economy by year's end.

Chart 2
Inflation breakdown (% y/y change) (Index 2003=100 and million people)



Source: BBVA Research and Banxico

Chart 3
Total exports and imports (% annual change)



Source: BBVA Research and Banxico

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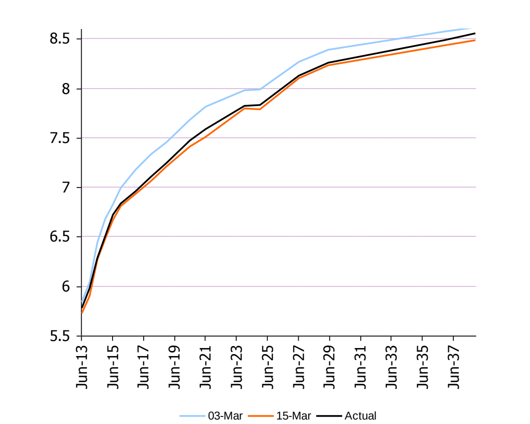
Markets

Yields fluctuation increased over the last four weeks in the face of high global uncertainty. Having increased by over 40 pbs during February and the first days of March, bond yields over 10 years experienced a correction of 30 pbs in merely a week and a half. Overreaction to the rise of the curve suggested that on the short term there was ample margin for a rates fall. The 10-year bond plunged to 7.5% (from 7.8%), a very close level to the 7.45% support level that we forecast. However, due to the high degree of uncertainty linked to the coincidence of various shocks – political tensions in the Middle East and the natural disaster in Japan– and based on our opinion that cyclical factors will regain importance gradually in the debt markets, we believe that bond prices will again fall in the coming weeks. With this in mind, we have recommended short positions in the medium and/or long terms, or to establish *Bear flattener* strategies between the back nodes and the *belly* of the curve as we expect the middle area to display a stronger reaction to this rise in performance. We also recommend taking advantage of the spread between the 130x1 and 26x1 swap which, should it reach 210 pbs (now 208), would allow us to gain in the long term and pay in the short term.

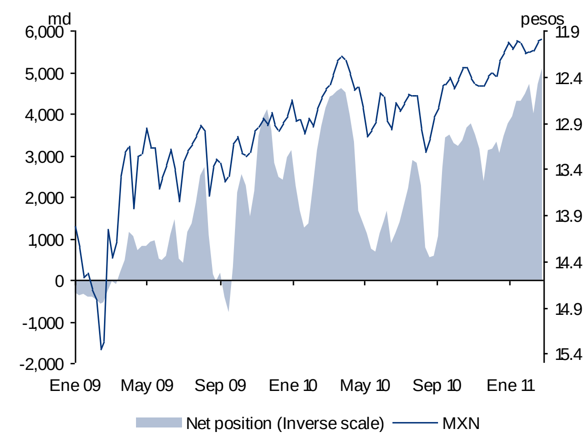
In a similar manner, the MXN fluctuated over a wide range (11.895-12.20) in reaction ot the risks related to the earthquake, tsunami and the possibility of a nuclear crisis in Japan. The currency closed in a stronger position at the close of business of Friday in response to the G7 joint intervention to contain the appreciation of the JPY and to the cease-fire in Libya. Still, the panorama is not totally cleared, and so we do not rule out new episodes of high volatility. In fact, implicit 1M volatility of the currency showed a weekly increase of 31.2%.
In keeping with information on March 15th, the net long-term speculative position for the MXN in the CME was at USD5.07bn (below USD772m of the historic maximum), which represents a weekly increase of USD355m. This datum does not include movement toward the 12.18 zone of the currency in subsequent sessions, which we expected to drop at the following reading. Considering that depreciation over the last three days of the week was 0.5%, the close of positions should not be very intense. Therefore the risk of new barriers linked with risk aversion phenomena continues. Likewise, a result close to that of the first week of April (USD4.7bn) would limit the possibility of the new long-term MXN positions in the short term.

Chart 5
Bond yield Curve (%)



Source: BBVA Research with Banxico data

Chart 6
MXN Long non-commercial position in CME (US$million)



Source: BBVA Research with data from Bloomberg

Mexico City, March 18, 2011

Market Analysis

Equities

Technical Analysis

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Technical Analysis

CPI

Source: BBVA, Bancomer, Bloomberg

CPI: Closes the week close to the 35,000 points zone, the minimum of November, but unable to take off from this support. During the last four sessions it operated below this level, always reaching it at the close, which would indicate that investors are considering this zone as an important support. With the majority of issuers heavily weighted in the CPI in the oversell zone and operating under the 2nd standard deviation in short-term regressions, we should begin to see a reaction by the CPI, to return at least to the high part of the channel, around 36,500pts.

Previous record: We can assume an upturn in the CPI from these levels, possibly to 36,800/36,900pts, although we have to ensure that the US market does not give out signs of a change in trend.

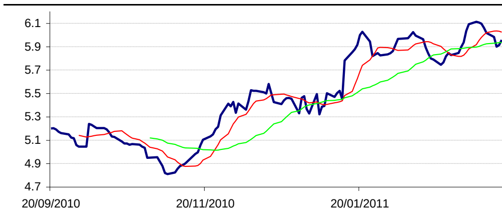
MXN

Source: BBVA, Bancomer, Bloomberg

MXN: Although it started the week with a fluctuation under the floor of P$11.95, the tendency quickly changed and the currency rebounded toward the higher zone of the range to P$12.20, where it encountered new resistance. We believe that it will again go to the support zone of P$11.95.

Previous record: A breakthrough below this level would make P$11.80 the target, P$0.20 below the support zone, which corresponds to the limits within which it moved in the lateral range.

3Y M BOND

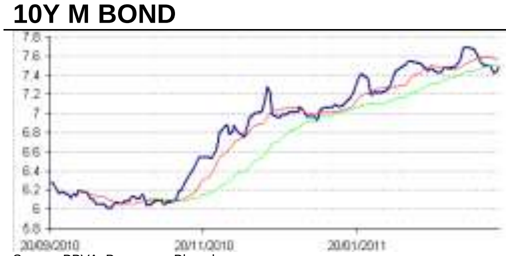


Source: BBVA, Bancomer, Bloomberg

3Y M BOND (yield): Returns to the 30-day moving average.(5.9%). For now the upward trend continues, with a rebound foreseen around the 6.2% level. Support levels at 5.9% and 5.75%.

Previous record: This means the next sticking point is at 6.2% and base levels at 6% and 5.91%. The uptrend is still in force.

10Y M BOND



Source: BBVA, Bancomer, Bloomberg

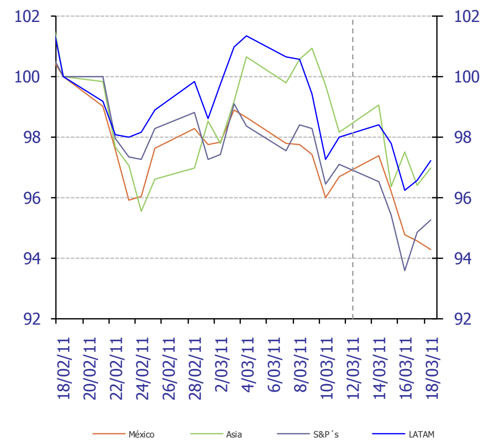
10Y M BOND: (performance): Adjusts and settles below the 30-day rolling average. Important support at 7.4%. Should this level be broken downward, the short term tendency would change, with support levels at 7.2% and 7%.

Previous record: Overbuying in the oscillating indicators continues, but the trend can continue upward with the next target at 7.8%.

Markets

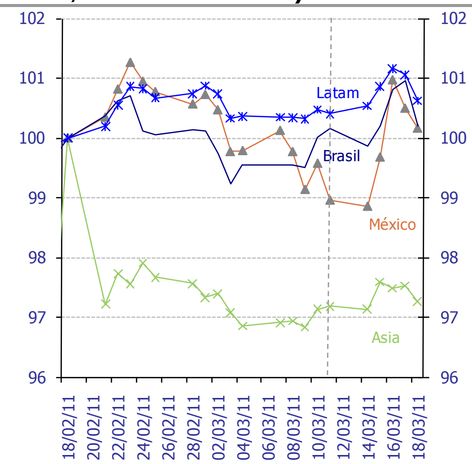
The Mexican stock market breaks away from the highs of Latin America, influenced at the closing date by derivative contracts in Wall Street and uncertainty in the global panorama. The peso rises before the reduction in risk aversion without recovering the losses of the week

Chart 5
Stock Market: MSCI indices (Feb 18 index = 100)



Source: Bloomberg & BBVA Research

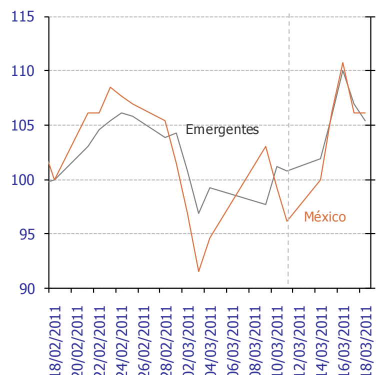
Chart 6
Foreign currencies: dollar exchange rates (Feb 18, 2011 index = 100)



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.

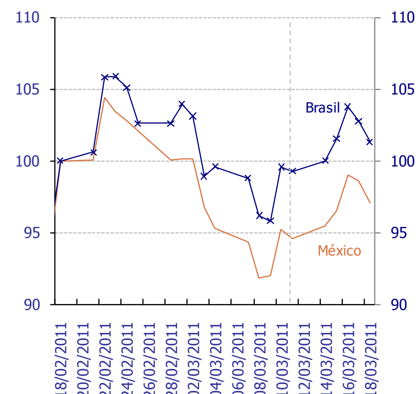
Fall in risk aversion influenced by the announcement of the ceasefire n Libya and the G7 agreement to slow the rise of the Yen

Chart 7
Risk: EMBI+ (Feb 18, 2011 index = 100)



Source: Bloomberg and BBVA Research.

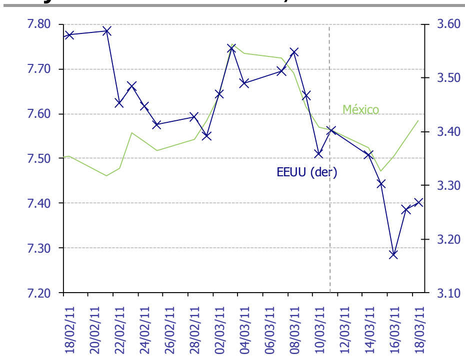
Chart 8
Risk: 5-year CDS (Feb 18, 2011 index =100)



Source: Bloomberg and BBVA Research.

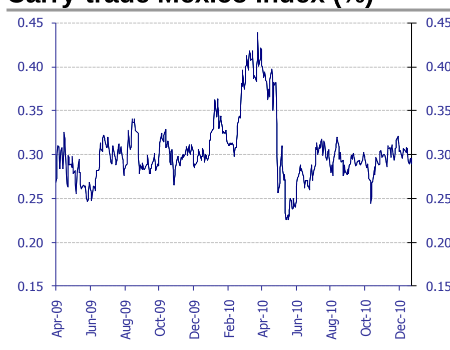
Increase in rates in the USA in light of lower risk aversion on the part of investors. Rates in Mexico rise congruently

Chart 9
10-year interest rates*, last month



Source: Bloomberg and BBVA Research

Chart 10
Carry-trade Mexico index (%)

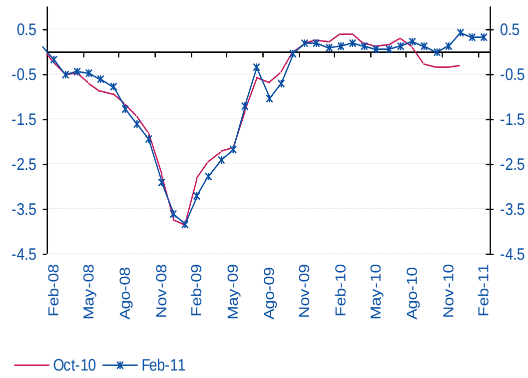


Source: Bloomberg and BBVA Research

Activity, inflation, monetary conditions

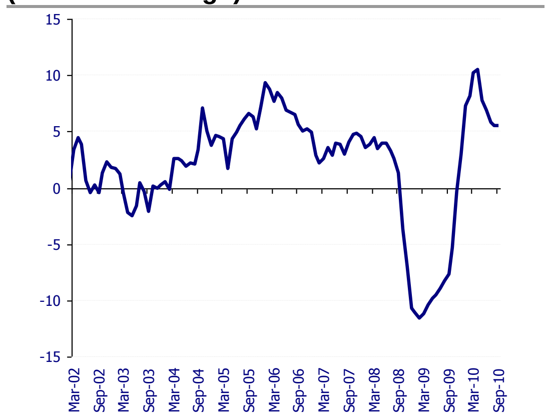
Economic activity in Mexico has improved as a result of foreign demand while domestic demand is recovery at a slower pace.

Chart 11
BBVA Research Synthetic Activity Indicator for the Mexican economy



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

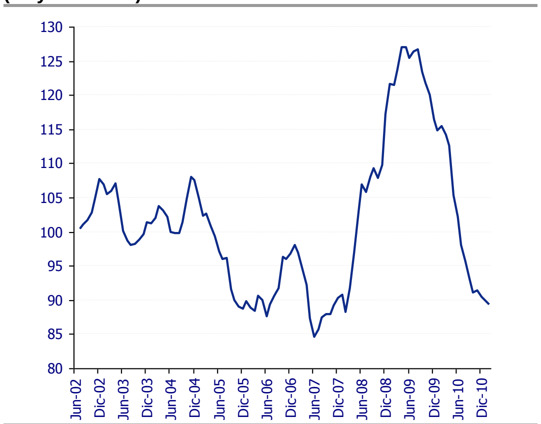
Chart 12
Advance Indicator of Activity (% annual change)



Source: INEGI

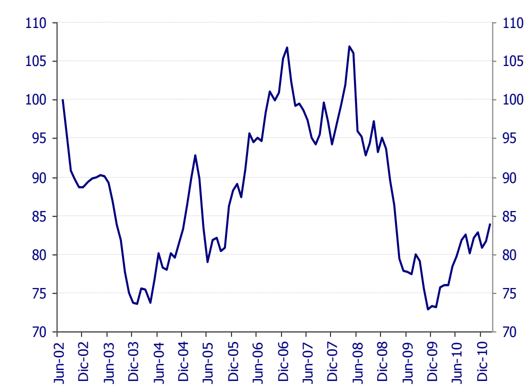
Inflation surprises fell throughout most of 2010, while activity surprises were slightly upward.

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.

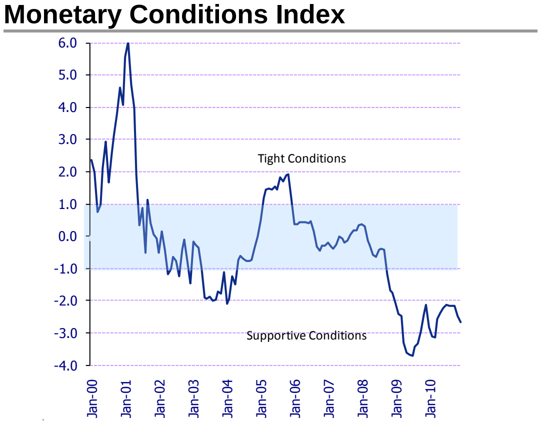
Chart 14
Activity Surprise Index
(2002=100)



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.

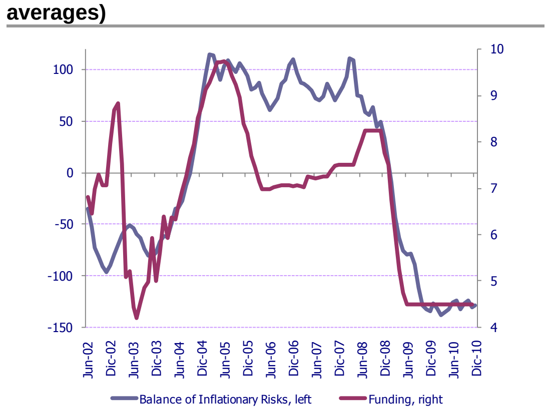
The monetary conditions in which the economy is moving continue to be helpful, although with a slight deterioration in the balance of inflationary risks.

Chart 15
Monetary Conditions Index



Source: BBVA Research

Chart 16
Balance of Inflationary Risks* and Lending Rate (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 points to a greater weight of inflationary risks compared to growth and thus a greater possibility of monetary restriction

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