BBVA Research

Mexico

Weekly Watch

April 8, 2011

Next week…

Economic Analysis

Iván Martínez
ivan.martinez.2@bbva.bancomer.com

No change to lending rate. Risk perspective in line with upturn in the last quarter of the year.

Since the last meeting, economic activity data have been better-than-expected, while inflation remains within the range forecast by Banxico despite adverse weather conditions in past months and the international rise in commodity prices. Nonetheless, the upswing continues to be a key factor in the decline in the balance of inflationary risks signaled by the Central Bank in the last release. In fact, this was clear in the minutes where greater discussion took place on the effects of these price rises on inflation, without forgetting that the key factor in monetary policy decision is inflation forecasts. In this scenario it is reasonable to believe that the Bank of Mexico will keep the lending rate at 4.5%. However, the increase in risks on the international backdrop and economic activity performance are in line with a possible rise in the lending rate in the last quarter of the year. This is when economic activity performance and continued commodity price pressure could put the anchoring of medium-term inflation forecasts at risk.

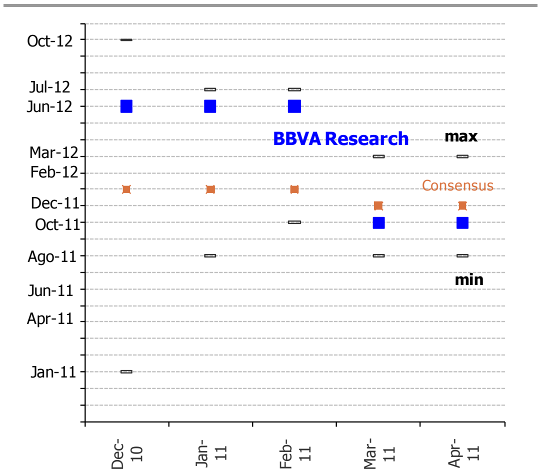
Market Analysis

Macro LatAm Strategy
Chief Strategist
Octavio Gutiérrez Engelmann
o.gutierrez3@bbva.bancomer.com

Weekly MXN appreciation and curve decorrelation for Mexico and the US point to major inflows

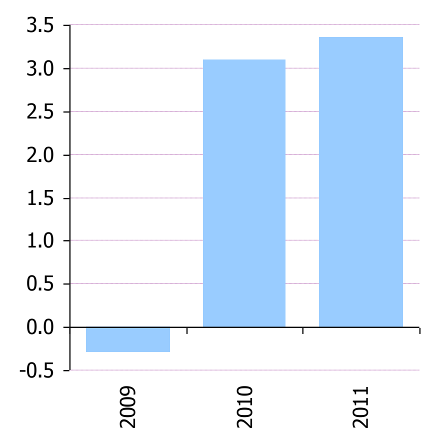
Favorable cyclical forecasts, less harsh ECB monetary signals, a major inflow in fixed income in Mexico, favorable surprise inflation data and statements from the Banxico Governor marked a week with gains in the MXN and major decorrelation between curve yields in Mexico and the US (which has never been seen at this size and in consecutive weeks). Although this week points to a continued appetite for risk on international markets with the beginning of corporate reporting in the US, we cannot rule out technical adjustments in the MXN and that the mid and long section of the curve approaches minimums.

Chart 1
Forecast lending rate rise date



Source: BBVA Research and Banamex

Chart 2
Mexico: foreign capital flows to the domestic bond market (USD bn)



Source: BBVA Research

Economic Analysis

Calendar: Indicators

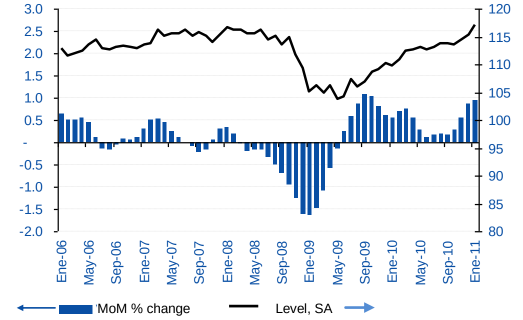
Industrial production for February

Monday, April 11: 0.7% m/m, 6.2% y/y. (previous: 1.4% m/m, 6.6% y/y)

Cecilia Posadas
c.posadas@bbva.bancomer.com

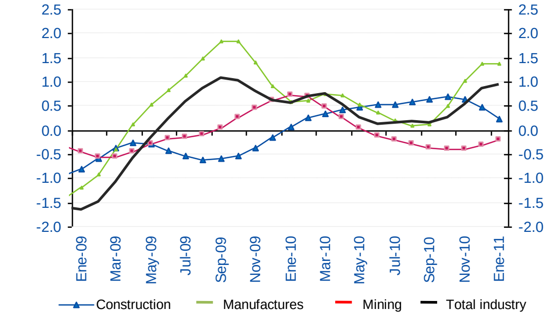
After the positive surprise in industrial production performance last January, February will continue to show expansion in the sector, albeit at a slightly lower rate (we estimate 0.7% CSV). As has been the case in recent months, the main factors to industrial performance are found in the manufacturing sector and, specifically, in branches where recovery due to foreign demand has stood out such as IT equipment, the automotive industry and machinery. In turn, the branches with a greater dependence on the domestic cycle will continue to recover at a slower rate. It should be stated that based on the dynamism seen last week in the producer confidence indicator, industry could have seen a pause in recovery in March which may be due to a variety of factors including the earthquake and tsunami in Japan which affected production lines in major branches for Mexico such as the automotive industry.

Chart 2
Industry (m/m% Trend and Level)



Source: BBVA Research

Chart 3
Industrial Production (% change m/m, Trend)



Source: BBVA Research

Market Analysis

Macro LatAm Strategy
Chief Strategist
Octavio Gutiérrez Engelmann
o.gutierrez3@bbva.bancomer.com
+5255 5621 9245

Fixed Income Analysis
Mexico/Brazil
Chief Strategist
Ociel Hernández
o.hernandez@bbva.bancomer.com
+5255 5621 9616

Liliana Solis
liliana.solis@bbva.bancomer.com
+5255 5621 9877

FX Mexico // Brazil
Claudia Ceja
claudia.ceja@bbva.bancomer.com
+5255 5621 9715

Technical Analysis
Alejandro Fuentes
a.fuentes@bbva.bancomer.com
+52 55 5621 9975

Markets

The MXN appreciated by 0.82% last week due to external and domestic factors: a long MXN position is recommended at any return to 11.85

The market remained mindful of Fed minutes and the ECB decision, whose less *hawkish* than expected tone led to a wider appetite for *carry-trade strategies*. In turn, stock markets in the US saw higher gains and the MXN continued to react to economic forecasts for the neighboring country. Locally, the fixed income rally continued to point to foreign capital inflows.

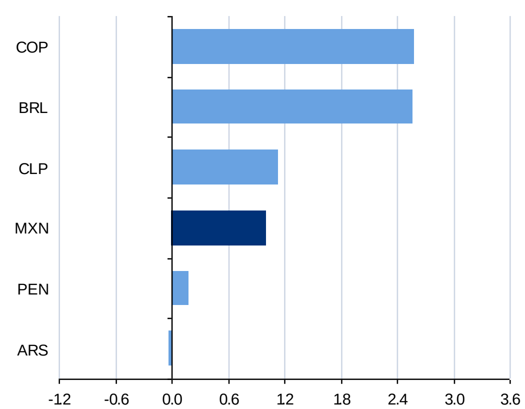
This week the US reporting season could lead to a continued appetite for risk. We see, however, factors starting to align for a short-term correlation: technical oscillators (RSI) attaining oversell levels, upward adjustment expectations for domestic curve yields and a possible USD recovery due to economic news. In any case, we continue to recommend taking long MXN positions in the face of any return to the 11.85 zone.

Major decorrelation between the Mexico and US yield curve due to the favorable inflation data, Banxico Governor statements and capital inflows.

The curve ended the week with a 13bp rally (10-year bonds) while T-Bills in the US rose 16 bp. Since October 2010, we have seen days where this decorrelation between the curves was recorded, especially if the US yields were adjusted downward. We have not seen such a significant size or for several consecutive sessions.

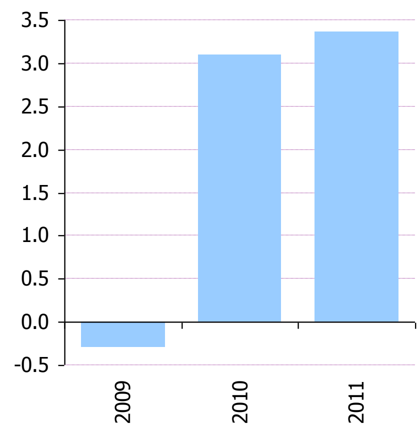
The positive inflation data, plus the persistent effects of the statements by the Governor of the Bank of Mexico with regard to the present monetary policy position, were major drivers behind the curve adjustment. However, anecdotal information suggests foreign capital inflows were behind this major demand in the curve. In the year to date, around 3.4 bn USD Bonds have come onto the bond market, against 3.08 bn USD in 1Q10. This means that the major demand that dominated in 2010 overseas continues. In 1Q11, the overseas holding went from 30% in January to 32% in March.

Chart 5
Weekly changes in LatAm currencies (%)



Source: BBVA Research and Bloomberg

Chart 6
Mexico: foreign capital flows to the domestic bond market (USD bn)



Source: BBVA Research

Technical Analysis

Mexico City, March 18, 2011

Market Analysis

Equities

Technical Analysis

Alejandro Fuentes Pérez (*)
a.fuentes @bbva.bancomer.com
5255 5621 9705

(*) Writer(s) of the report

CPI Stock Market Index

Source: BBVA, Bancomer, Bloomberg

CPI: the CPI adjustment came after a major bounce and just when the psychological barrier of 38,000 pts was hit. We had already stated that the market could find it difficult to break this barrier at first given the major gain in previous weeks. We see this fall as normal and simply obeying a temporary correlation within the upward trend that began when the market closed above the 30-day rolling average. The support level we see as a good entry point falls between 37,000 and 36,700 pts, where the 30-day rolling average stands, while above 38,000 pts the market would set the next barrier at 38,600 pts.

Previous rec.: 38,000 pts could represent short-term resistance if we take into account that, as well as being a psychological level, the market has bounced by almost 2,500 pts in the last two weeks.

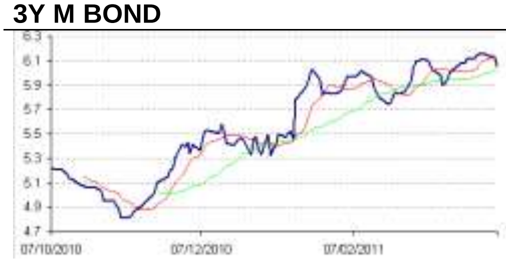
MXN

Source: BBVA, Bancomer, Bloomberg

Adjustment persists throughout the week. As stated, the support level falls between P$11.70 and P$11.60, where it would meet the base of the negative range in the weekly chart. Any bounce will find resistance in the 10-day rolling average (P$11.90) and we can only consider a new upward trend from P$12.00.

Previous rec.: The possibility of a move towards the P$11.70/11.65 zone opens corresponding to the lower negative range section on the weekly chart.

3Y M BOND



Source: BBVA, Bancomer, Bloomberg

3-YEAR M BOND (yield): It has already come in below the 30-day rolling average opening up the possibility of an adjustment towards support levels of 5.9% and 5.8%.

Previous Rec.: Resistance at 6.3% and support at 5.97%.

10Y M BOND

Source: BBVA, Bancomer, Bloomberg

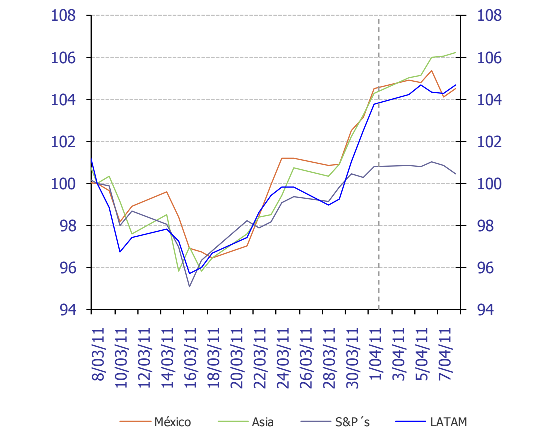
10 Y M BOND (yield): Obeying the oscillator signs, heading toward a floors at 7.2%. Resistance at 7.36% and 7.47%.

Previous rec.: Continues to show signs of adjustment with support at 7.2%.

Markets

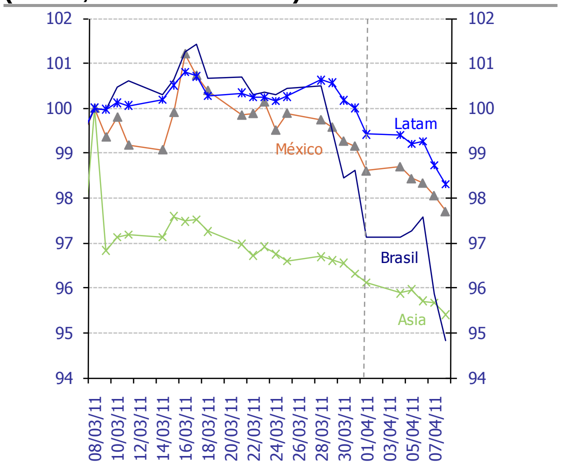
Slight upswing in markets toward week-end without major economic announcements and with caution in the face of the coming start of the quarterly reporting season. Peso appreciation supported by the major capital inflows on the domestic market and statements from the Banxico Governor on the absence of inflationary pressure in the present scenario of economic growth

Chart 5
Stock markets: MSCI indices (Mar 8, 2011 index= 100)



Source: Bloomberg & BBVA Research

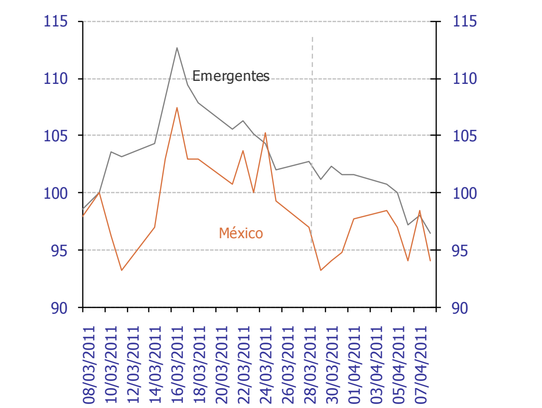
Chart 6
Foreign exchange: Dollar Exchange Rates (Mar 8, 2011 index=100)



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.

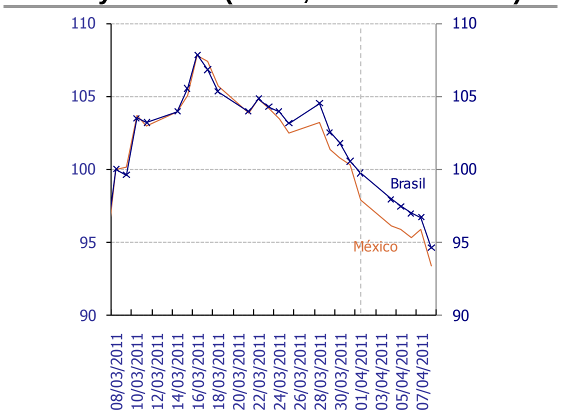
Continued fall in risk aversion due to a scenario with no major economic announcements and with latent risks due to the Middle East.

Chart 7
Risk: EMBI+ (Mar 9, 2011 index = 100)



Source: Bloomberg and BBVA Research.

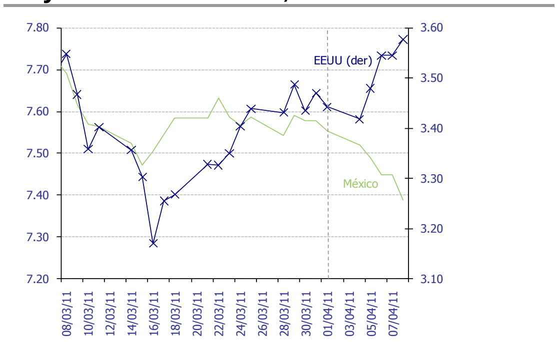
Chart 8
Risk: 5 year CDS (Mar 8, 2011 index=100)



Source: Bloomberg and BBVA Research.

US rates up due to higher inflation forecasts due to the "concern" that the FED's accommodative position persisting longer than required. Rate in Mexico down after statements from the Banxico Governor which were interpreted as a factor favoring a stable lending rate without change in 2011.

Chart 9
10-year interest rates*, last month



Source: Bloomberg and BBVA Research

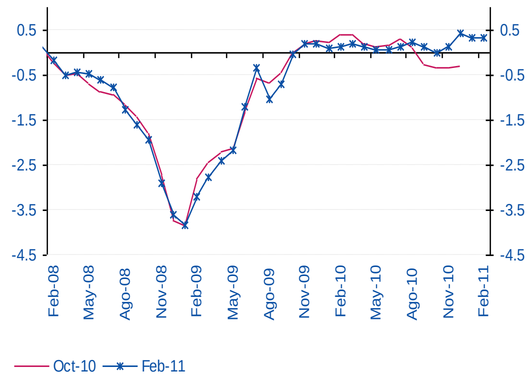
Chart 10
Carry-trade Mexico index (%)

Source: Bloomberg and BBVA Research

Activity, inflation, monetary conditions

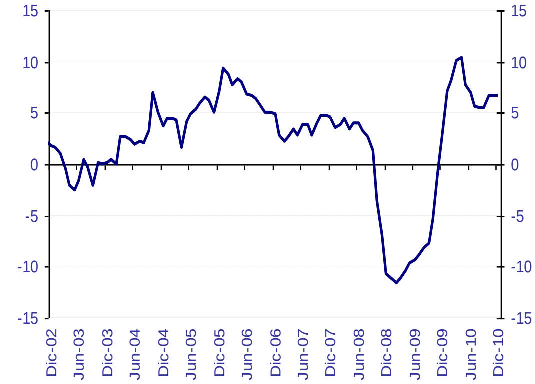
Economic activity in Mexico bounced in the last quarter of 2010 and recent data even saw positive surprises.

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.

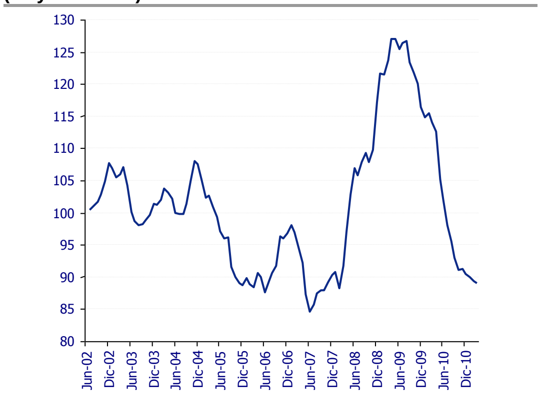
Chart 12
Advance Indicator of Activity (% change y/y)



Source: INEGI

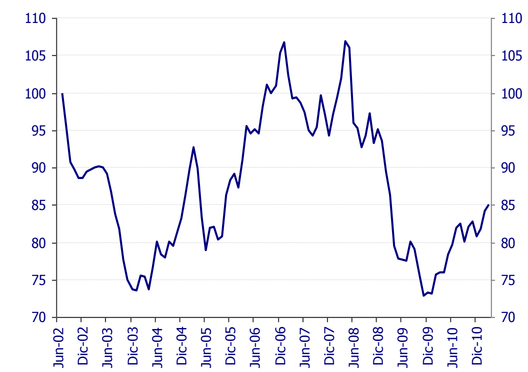
The inflation surprises continued to be slightly downward. While surprises in economic activity were slightly upward

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.

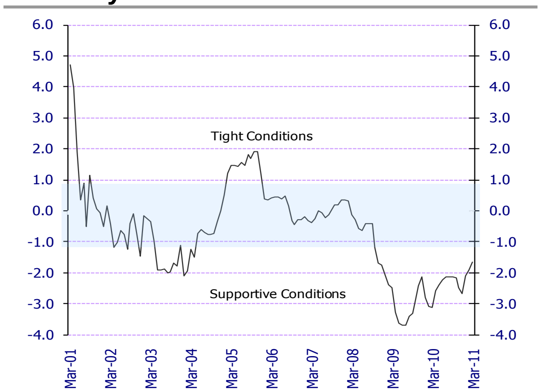
Chart 14
Activity Surprise Index
(2002=100)



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.

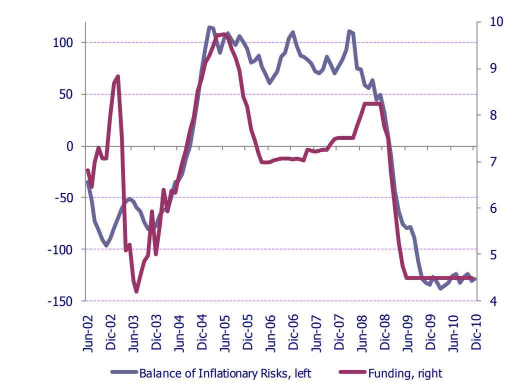
The monetary conditions in which the economy is moving continue to be helpful, although with a slight deterioration in the balance of inflationary risks.

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 signals greater weight of inflationary risks over those of growth and, therefore, more likelihood of monetary restriction

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