Weekly Watch

Mexico

April 29, 2011

Economic Analysis

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Market Analysis

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Next week...

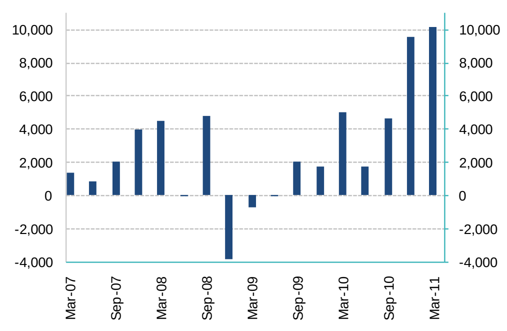
First glimpse at the cyclical tone in the second quarter of the year

Next week will provide an initial glimpse of how 2Q11 is going in output terms after the 1Q11 came in more positive than forecasts at the start of the year for growth, with inflation slightly lower too and foreign capital inflows into Mexico surpassing maximum levels seen at the end of 2010. With regard to prices, the minutes published by Banxico today on its monetary policy on April 15 maintain a forecast for inflation to continue to fall in line with the bank's forecast, although they also state uncertainty linked to the exchange rate, *commodities* prices and the domestic demand growth rate. All this comes in the midst of a higher oil price whose net effect on the Mexican economy seems to be positive as long as US growth does not derail – something we do not consider in the baseline. In this way, we will see how formal employment performed in April in second quarter output for the year in Mexico, which we expect to see maintain its near 0.3% m/m growth rate (more details on page 2).

Factors in play on the market: international liquidity, economic uncertainty and a positive balance for local inflation to present.

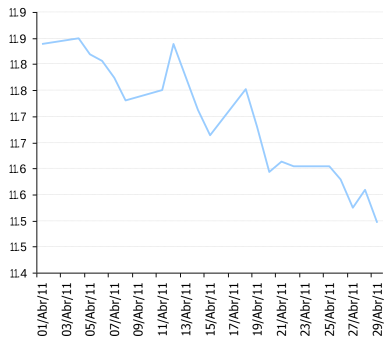
The appetite for risk assets was again driven by the US Federal Reserve. In short, both the Fed release and the later press conference by Bernanke foresee liquidity injected through quantitative measures by the Central Bank not being withdrawn in the short term. This implies carry strategies continuing that favor emerging market currencies and weakening the dollar against the main global currencies. The peso appreciated by 0.72% and domestic curve yields fell 8bp on average. Treasuries also advanced, pointing to continued demand in the face of uncertainty around the US economic growth rate which, until present, has supported the benchmark rate remaining at truly low levels for a prolonged period. It should be stated that this economic uncertainty only concerns the growth rate (and not a major slowdown), explaining why the aversion to risk is not rising as well as the positive effect of the high global liquidity level.

Chart 1
Mexico: foreign capital inflows into public debt (USD million)



Source: BBVA Research

Chart 2
MXN exchange rate



Source: BBVA Research and Bloomberg

Calendar: Indicators

Formal private-sector employment April

In the week 0.3% m/m and 4.6% y/y (previous 0.4% m/m, 4.7% y/y)

Confidence April

Producer: Tuesday, May 3 4.2% m/m 14% y/y (previous -1.6%, 13.7% y/y)
Consumer: Wednesday, May 4 0.3% m/m 12.8% y/y (previous -0.4% m/m, 14.1% y/y)

Economic Analysis

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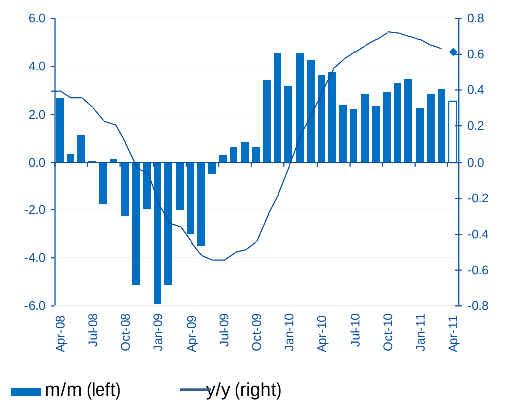
This week is filled with the first indicators for the 2Q11, especially forecasts but also employment. Formal private-sector employment will continue to see a high growth rate, around 0.3% per month, where it has remained for 18 months. This has been a main factor in recovering jobs lost in the crisis (formal private-sector). As in other months, the manufacturing and services growth rate will continue to stand out. It will be especially important to find out construction sector performance where volatility has been the main factor.

Producer and consumer confidence indicators will also be released. With regard to producers, we forecast that the negative surprise seen in this indicator in March could reverse in part in April. This fall could have been linked to a reaction in a manufacturing sector to the earthquake and tsunami in Japan on March 11. It should be stated that the marked variations were the main feature to manufacturing in recent months, influenced by export branches with higher growth (including automotive and basic metals) which, in turn, are some of the most volatile in US output.

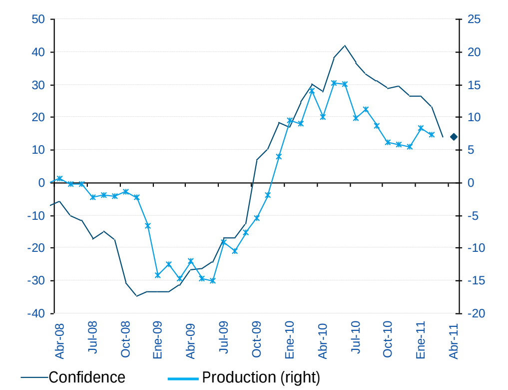
Lastly, consumer confidence will continue its moderate growth. It will be especially important to watch for consumer opinion on the possibility of purchasing a durable good in coming months which will provide information on the pick-up speed in retail sales indicators. The performance of disposable income is a support for improved confidence and household spending.

Chart 3
Formal private-sector employment



Source: BBVA Research and INEGI

Chart 4
Producer confidence and Manufacturing Production (y/y % change)



Source: BBVA Research and INEGI

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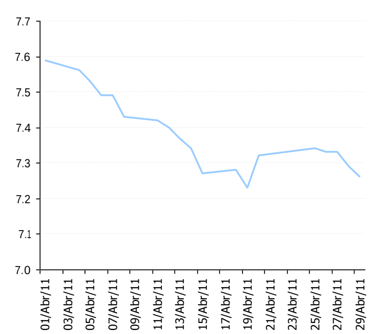
Curve appetite

The appetite for risk assets was again driven by the US Federal Reserve. This implies carry strategies continuing that favor emerging market currencies and weakening the dollar against the main global currencies. his setting is supported by the scenario feeding overseas demand for bonds. In turn, the inflationary situation in Mexico, as well as the soft tone from authorities, finally triggered greater appetite among local investors for the curve. We stress that the fact of the curve slope (between long and short term) increasing, and less so the slope for the long part with the medium, is adapting to the curve to maintain or open up Flattener strategies. If inflation continues to surprise, the long part still has room to move down. But if the present rally is coming to an end, and the cycle has weight again in coming weeks, demand from Beat Flatteners will increase. Especially since an unstable inflation scenario is not appearing and curve appetite has increased. Despite falling, the medium sections moved less than the short part; in this way, the steepness of the curve has increased, making medium vs. short Flattener positions attractive, and even more so taking into account the curve level (we will assess market conditions to make a decision on taking positions). Our 2Y/10Y – 1Y/2Y curve flattening strategies remain open (entry was 205 and 68 bp and targets at 150 and 40 bp, respectively).

High liquidity forecasts for a prolonged period continue to favor the peso

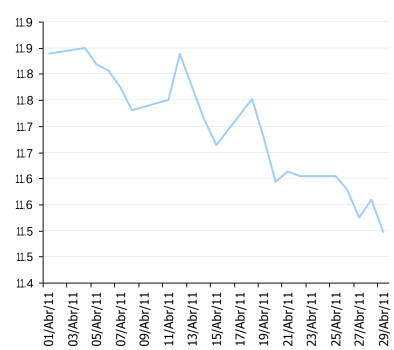
Last week the performance of the global currency market was defined by expectations following the decision of the FOMC and Ben Bernanke's press conference. In this way, the Committee's accommodating tone led to a new fall in the USD against emerging and developed currencies. In this context, forecasts for excess liquidity point to continued inflows into carry strategies, favoring mostly LatAm currencies in the short-term. However, it is important to point out that the correction risks (at least in the face of profit-taking) are starting to become ever more present: 1) the long MXN position on the CFTC is near historic maximums, 2) we see a high probability for an increase in auction amounts at the end of the month from Banxico and 3) technical indicators point to a continued fluctuation in the currency in the excess over-sell zone. In all, we will watch US economic data closely in coming weeks.

Chart 5
M10 (%)



Source: BBVA Research with Banxico data

Chart 6
MXN exchange rate



Source: BBVA Research with data from Bloomberg

Technical Analysis

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CPI Stock Market Index

CPI: The CPI failed to correlate with this move in the US and ended the week just below the 30-day rolling average with a -1.6% fall in April. Since several CPI issuers, some with high market weighting, came in at major support levels and high oversell readings, it is highly likely that the CPI sees an attempt at a technical bounce in coming days. While we see a downward movement toward 36,250 pts (-1.6%) as limited, an upward break in the 10 and 30-day rolling averages (36,920 pts) would place the next target level at 38,000 pts (+3.2%).

Previous rec.: 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.

Source: BBVA, Bancomer, Bloomberg

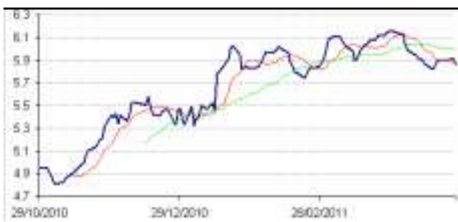
MXN

The dollar hit the psychological level of P$11.50 in the week. At these levels, the dollar is trading in the low part of the negative range on the weekly chart and we believe we could see a technical bounce in the short-term. This rebound might encounter resistance at P$11.80 and P$12.00. If the floor is broken downward, the following support level would be P$11.40.

Previous rec.: 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.

Source: BBVA, Bancomer, Bloomberg

3Y M BOND

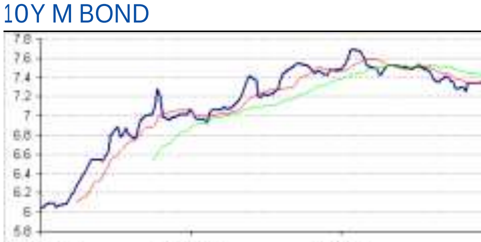


BOND M 3A (performance): Remains below the 10 and 30 day moving averages meaning that the downward move remains in play. Next resistances at 5.8% and 5.6%.

Previous rec.: This opens up the possibility of a correction toward supports at 5.9% and 5.8%.

Source: BBVA, Bancomer, Bloomberg

10Y M BOND



10 YEAR M BOND: (performance): The weekly bounce is not enough to again come in above short-term rolling averages. Resistance at 7.27% and 6.98%.

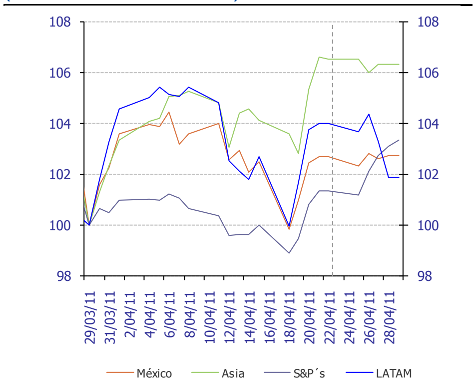
Previous rec.: Obeying the oscillator signs and heading toward a floor at 7.2%.

Source: BBVA, Bancomer, Bloomberg

Markets

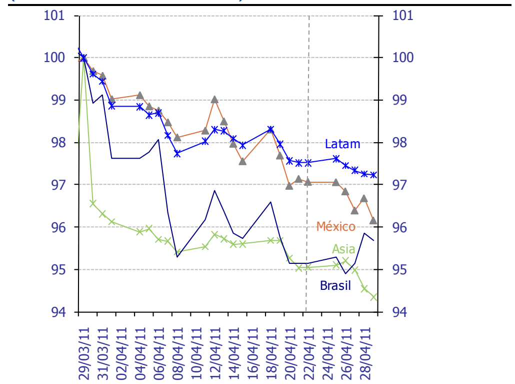
Upswing in US stock markets on the FED announcement that it will keep the federal rates unchanged and better-than-expected corporate reporting. In Mexico, the market saw a marginal upward move. The peso continues to appreciate in the face of a search for higher-yield assets.

Chart 7
Stock Markets: MSCI Indices
(Mar 29, 2011 index = 100)



Source: Bloomberg & BBVA Research

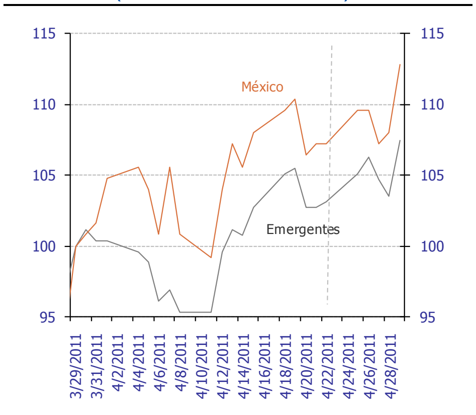
Chart 8
Foreign exchange: dollar exchange rates
(Mar 29, 2011 index = 100)



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

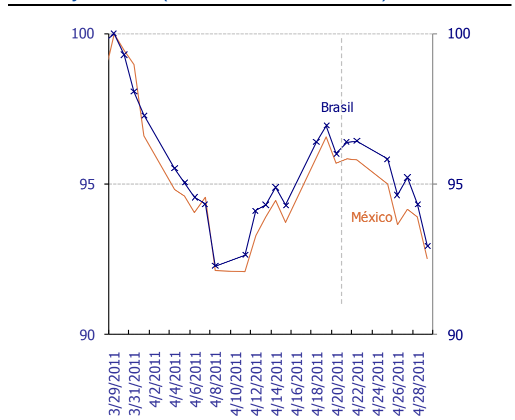
Marginal fall in risk aversion due to forecasts for lax monetary conditions to continue

Chart 9
Risk: EMBI+ (Mar 29, 2011 index = 100)



Source: Bloomberg & BBVA Research

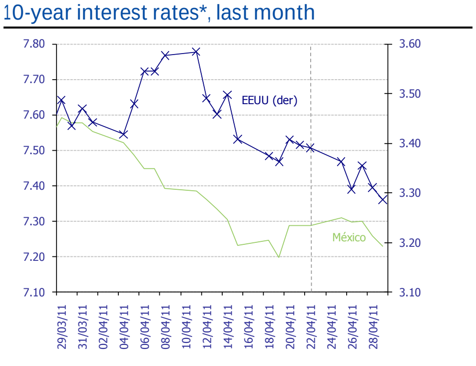
Chart 10
Risk: 5 year CDS (Mar 29, 2011 index=100)



Source: Bloomberg & BBVA Research

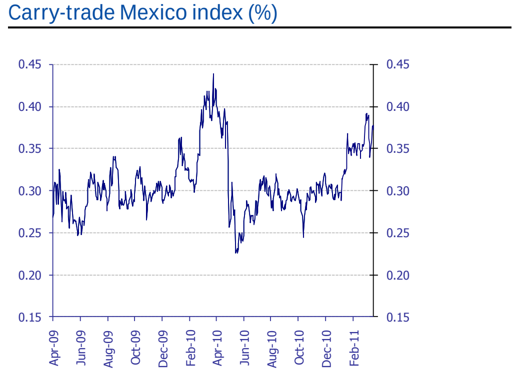
Decline in US interest rates due to lower-than-expected economic growth in the 1Q11. Rates in Mexico fall thanks to the good inflation figures and the expectations that Banxico will maintain its monetary pause.

Chart 11
10-year interest rates*, last month



Source: BBVA Research with Banxico data

Chart 12
Carry-trade Mexico index (%)

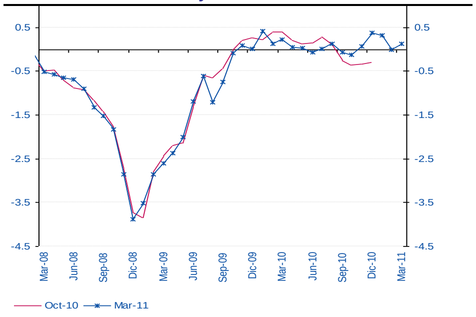


Source: BBVA Research with data from Bloomberg

Activity, inflation, monetary conditions

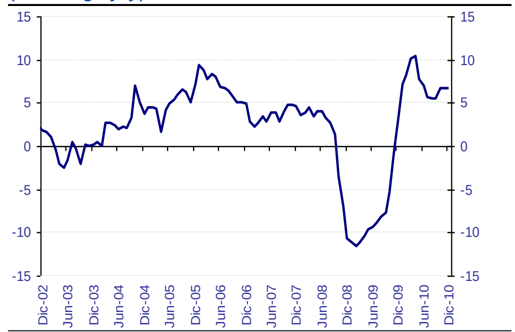
Activity saw a slightly better-than-expected performance at the end of 2010 in the first quarter

Chart 13
BBVA Research Synthetic Activity Indicator for the Mexican economy



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

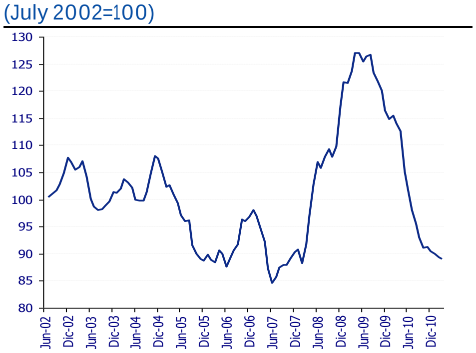
Chart 14
Advance Indicator of Activity
(% change y/y)



Source: INEGI

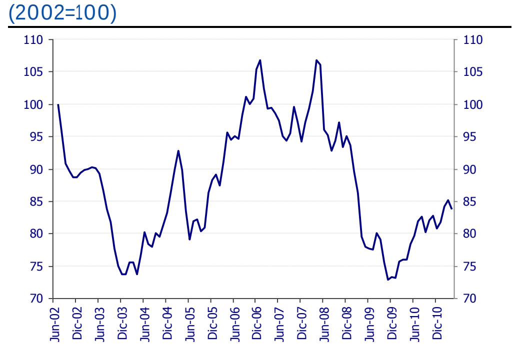
Inflation surprises continue to be slightly downward. While surprises in output are slightly upward

Chart 15
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.

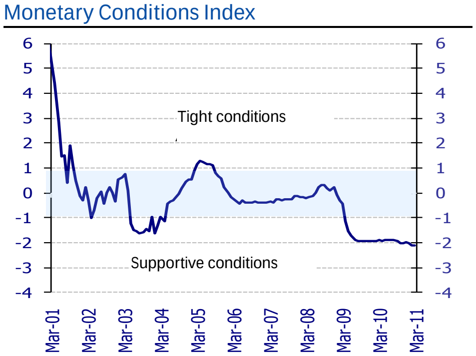
Chart 16
Activity Surprise Index
(2002=100)



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

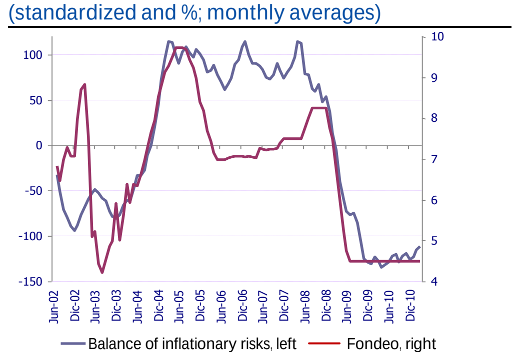
The monetary conditions in which the economy is moving continue to be helpful, although with a slight deterioration in the balance of inflationary risks

Chart 17
Monetary Conditions Index



Source: BBVA Research

Chart 18
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 index points to a greater weight of inflationary risks over growth risks and thus a greater possibility of monetary restriction

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