BBVA | RESEARCH

Weekly Watch

Mexico

May 20, 2011

Economic Analysis

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Next week...

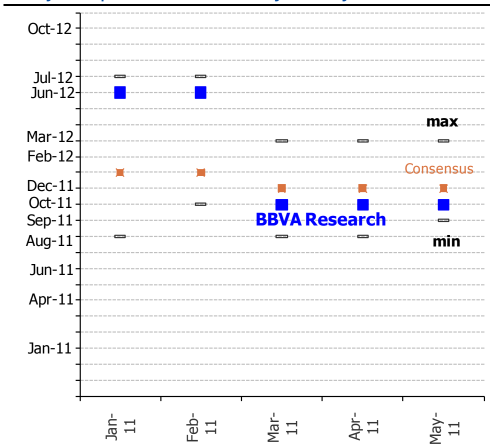
More information to be released by Banxico

This coming Friday, May 27 Banxico will release its monetary policy decision where we expect to see no changes. The lending rate should remain unchanged at 4.5%. However, we do forecast the bank's tone to show signs on the appearance or dilution of uncertainty factors for inflation we see as important this year – an increase in prices in coming months due to the performance of commodity prices and the speed at which the slack on certain markets could dissipate. The performance of these two factors is key for the future trajectory of the monetary policy rate.

Curve flattening strategies remain

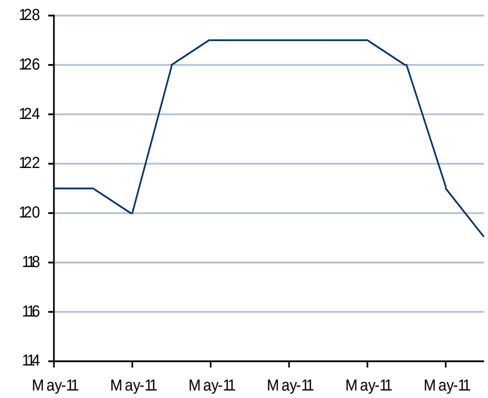
The curve continues to gain ground with the less favored *spreads* up to a week ago now dominating the flattening out. A week of high volatility for the MXN based on risk premium elements in the EU and uncertainty as to the global cycle. We expect the currency to continue to trade in a wide trading range with a short-term positive bias.

Chart 1
Analyst expectations: monthly survey



Source: BBVA Research and Banamex

Chart 2
Bond curve slope



Source: BBVA Research and Bloomberg

Calendar: Indicators

Economic Analysis

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Inflation for the first two weeks in May

Tuesday, May 24: Forecast: General -0.5% bi-weekly (Consensus -0.42%) Previous -0.01% m/m April

Next week sees the release of inflation figures for the first fortnight in May, a hugely important figure for inflation trajectory over the rest of the year since it will set the intensity at which inflation will bounce in the 2Q11 and 3Q11 and whether it will end in Banxico's target range. Inflation shows negative monthly rates in May due to the summer electricity rates coming into force. However, focus falls on the annual rate since last year said rate reduction came with major falls in agricultural prices and very limited core inflation. We believe the situation this May could be less benign since there is evidence of recent upswings in wholesale agriculture markets and electricity rates falling less as in the last year some of its supplies such as oil and coal have seen major price hikes. As for core inflation, it continues to show different performances in the processed food component and its other components. The first shows constant increases at an annual rate from November on (from 3.37% in October to 5.98% in April) while the other components have maintained a mainly downward trajectory. We expect core inflation to only rise by 0.12% bi-weekly due to food price pressures being partly compensated by declines in other service prices (tourism). In conclusion, inflation will continue to see an annual increase in May and, if it adjusts to our forecast, could come in around 4% y/y between August and September.

Commercial Establishments in March, Unemployment Rate in April

Commercial Establishments: 1.8% y/y, 0.3% m/m (previous: 2.7% y/y, 0.3% m/m)
Unemployment Rate: 5.3% (5.1% previously)

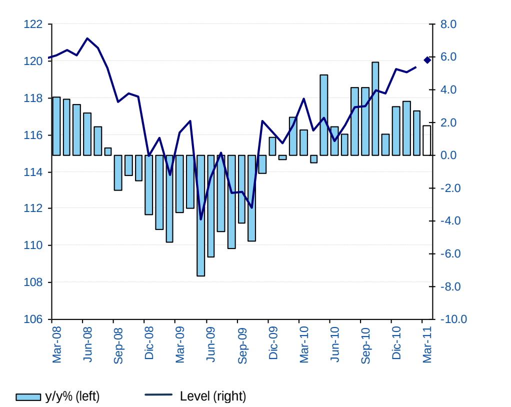
We believe that in terms of annual change, retail sales growth should be around 1.8%, somewhat below the first two months of the year. This may be linked to the pause in the durable goods recovery as indicated by consumer confidence data. This contrasts with the sustained growth in disposable household income in line with the performance of payroll on the formal market. The explanation for this contrast could come from the unemployment rate performance which, beyond its short-term volatility, is unable to fall below 5%. In this way, we expect April to see a slight bounce in seasonally-adjusted figures. This would be in line with the slowdown seen this month in job creation in the formal private sector.

Table 1
Inflation forecast for May (% change m/m and y/y)

	Peso	Monthly change (%)				Annual change (%)		
	(%)	2003-2009	Mar-11	Abr-11	May-11	Mar-11	Abr-11	May-11
CPI-Mx	**100.0**	**-0.31**	**0.19**	**-0.01**	**-0.39**	**3.04**	**3.36**	**3.61**
Core-Mx	*74.8*	*0.24*	0.30	0.08	*0.18*	3.21	3.18	*3.12*
Goods	37.0	0.33	0.48	0.35	0.33	3.97	4.07	4.17
Food products	14.7	0.48	0.90	0.58	0.60	5.55	5.98	6.34
Other Goods	22.4	0.22	0.17	0.17	0.14	2.75	2.60	2.51
Services	37.7	0.16	0.15	-0.15	0.06	2.57	2.44	2.26
Rent	17.9	0.28	0.21	0.20	0.20	2.10	2.19	2.14
Education	5.2	0.10	0.04	0.07	0.10	4.46	4.47	4.49
Other serv.	14.7	0.07	0.11	-0.56	-0.10	2.34	1.93	1.57
Non Core-Mx	*25.2*	*-2.18*	-0.16	-0.28	*-2.27*	2.46	3.90	*5.10*
Farm products	8.1	-0.48	-1.25	3.06	-0.29	-1.69	3.70	7.10
Fruits//Vegetables	3.3	-1.21	-3.05	7.22	-0.90	-6.36	5.71	14.32
Meat//Eggs	4.8	0.02	0.05	0.16	0.18	1.86	2.33	2.54
Public managed	17.2	-3.21	0.44	-2.11	-3.40	4.96	4.04	3.98
Energy	7.8	-5.20	0.76	-3.25	-5.40	5.96	5.00	5.15
Controled prices	9.4	0.10	-0.15	-0.03	0.11	3.27	2.62	2.59
					Monthly Revision			*Monthly Revision*

Source: BBVA Research with Banxico data

Chart 4
Retail Sales (Level and y/y%)



Source: BBVA Research and INEGI.

Markets

The curve continues to gain ground

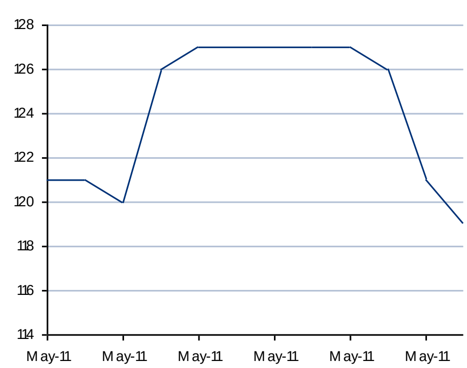
In a global risk aversion context favoring a purchase bias and gains in *Treasuries*, the local curve extended its rally seen over the week. The market has already started to partially correct the high slopes and curve level.

Conditions favoring the curve have not diluted: 1) flows; 2) aversion in Europe; 3) the perception of a prolonged monetary pause. This is why we have opened long positions in the back part and shorts in the medium. The short section could only have some run in it if inflation in the first two weeks of March, due in next Tuesday, again shows a positive surprise, although not too much since it is already in the over-buy zone, even in a longer pause scenario than that discounted now by the market. Watch closely: The medium part is again fairly slim with regards to the rest of the curve. The curvature level has not been so low since the beginning of January this year. In addition, the different between the 10-year MX-US is below 390bp, a level where foreigners have started to reduce the flow to the medium part (vs. other sections). With this, we restate our preference for the long vs. the medium part in a rally context but with risks of a rebound, mainly in the medium part: the curve is beginning to be expensive, the 2Y/10Y *spread swap* remains open.

The MXN will remain within a wide trading range.

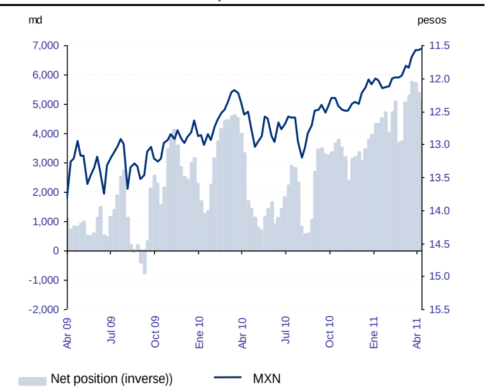
Last week the MXN was set by three factors: 1) uncertainty as to a possible restructuring in Greece; 2) expectations around Fed exit strategies with Fed minutes pointing to an internal split although economic data favor a *dovish* position; and 3) volatility in commodities. In short, the currency closed with a 0.69% rise and if we take into account the fall in the last three weeks in the long speculative MXN position on the CFTC, there is space to widen gains. In total, the aversion factors linked to more moderate growth and the fiscal situation on the periphery of Europe could continue to place pressure in the short-term. We therefore do not expect the dynamic of wide trading ranges to dissipate in coming days.

Chart 5
Bond curve slope



Source: BBVA Research with data from Bloomberg

Chart 6
Peso, non-commerce net position on the CFTC



Source: BBVA Research with data from Bloomberg

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Technical Analysis

IPC Stock Market Index

Source: BBVA, Bancomer, Bloomberg

IPC: Although the IPC closed below 35,000pts in the week, it quickly recovered to this psychological level. With two weeks hovering at this level, it continues to strengthen as a short-term support. The technical readings we commented on last week (high oversell, opening of over 1,000pts between 10 and 30-day rolling averages) remain present and the perspective of a short-term bull bounce remains valid. Short-term IPC resistance comes in at 35,860ots (200-day rolling average) and 36,200pts (30-day rolling average).

Previous rec.: we continue to believe that a technical upswing could be seen from these levels in line with the lessons on overselling. If the market is not able to respect this support, the following floor would come in around 34,200 pts.

MXN

Source: BBVA, Bancomer, Bloomberg

It started the week with a bull move toward P$11.80 and from this level a new adjustment move started already coming in below short-term rolling averages. We believe it could again come close to the P$11.50 zone to again try this floor.

Previous rec.: this break leads to the possibility of a move toward P$11.90 levels, while the support area comes in at P$11.60, where the 10 and 30-day rolling averages converge.

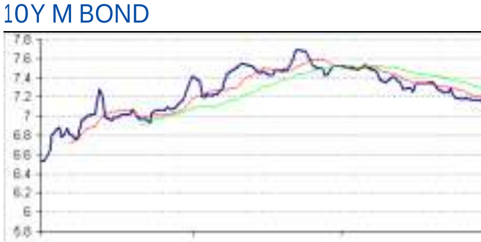
3Y M BOND

Source: BBVA, Bancomer, Bloomberg

3 YEAR M BOND: (performance): There is not bounce and it continues to trade below 10 and 30-day rolling averages. It may try floors at 5.55% and 5.51% - the 200-day rolling average level. A downward break would accelerate a negative move.

Previous rec.: it maintains its downward trend with support at 5.6%.

10Y M BOND



Source: BBVA, Bancomer, Bloomberg

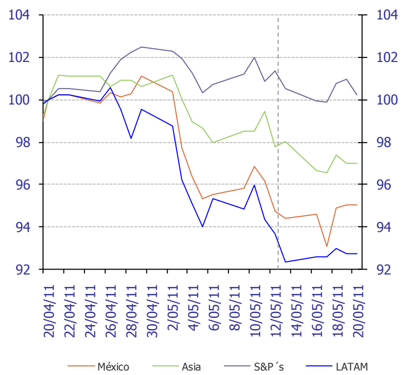
BOND M 10A (performance): it maintains a downward move with supports at 6.9% and 6.85% where the 200-day rolling average sits.

Previous rec.: Significant resistance comes in at 7.3% and only breaking this level would lead us to consider a trend change. Meanwhile, the following floor holds at 7%.

Markets

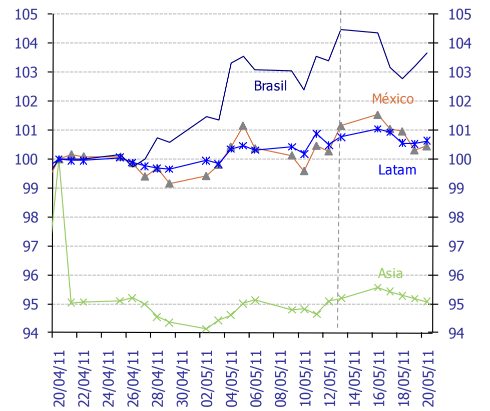
The stock market in Mexico detaches itself from the US fall due to increased fears over a moratorium in Greece. The exchange rate drops marginally despite dollar strength against other currencies.

Chart 7
Stock Markets: MSCI Indices
(Apr 20, 2011 index = 100)



Source: Bloomberg & BBVA Research

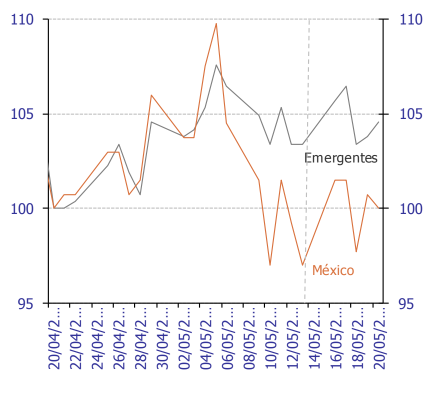
Chart 8
Foreign exchange: dollar exchange rates
(Apr 20, 2011 index = 100)



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

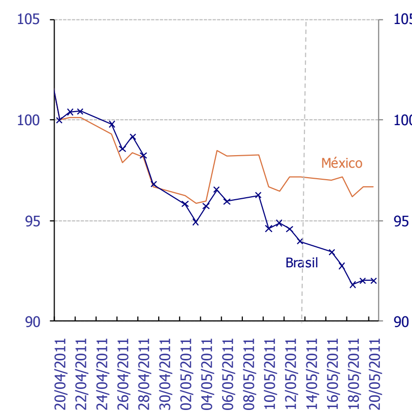
Risk indicators in Mexico show no sign of change after Greece's downgrading by Fitch due to the increased chance of default

Chart 9
Risk: EMBI+ (Apr 20, 2011 index = 100)



Source: Bloomberg & BBVA Research

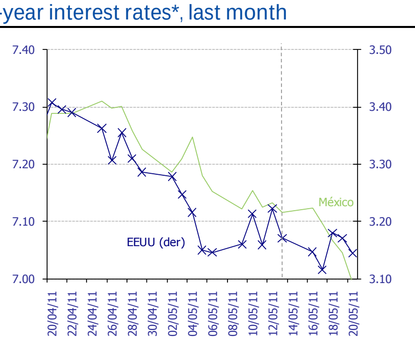
Chart 10
Risk: 5-year CDS (Apr 20, 2011 index=100)



Source: Bloomberg & BBVA Research

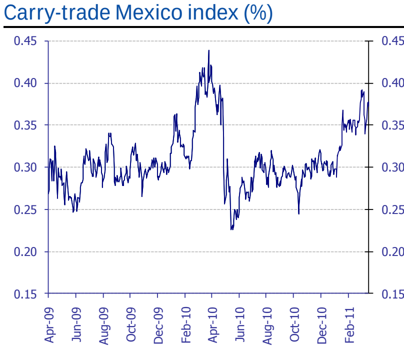
US interest rates fall due to investors searching for safe assets. Rates in Mexico fall influenced by a forecast slowdown in US growth

Chart 11
10-year interest rates*, last month



Source: Bloomberg & BBVA Research

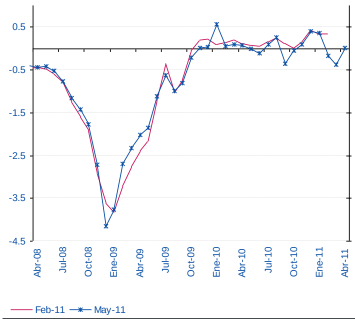
Chart 12
Carry-trade Mexico index (%)



Source: BBVA Research with data from Bloomberg

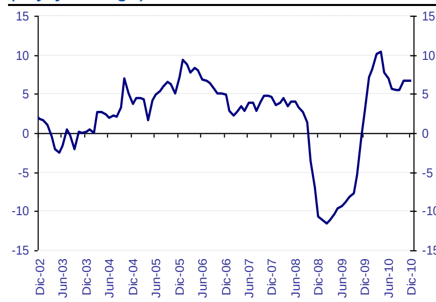
Activity, inflation, monetary conditions

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 indicators of activity, expenditure and expectation, based on trend series.

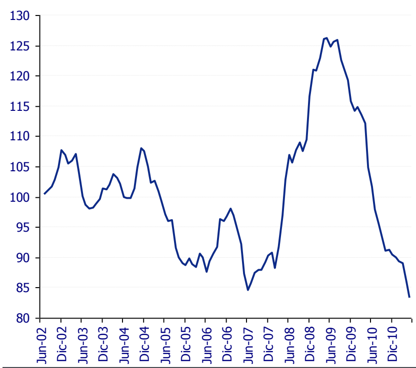
Chart 14
Advance Indicator of Activity
(% y/y change)



Source: INEGI

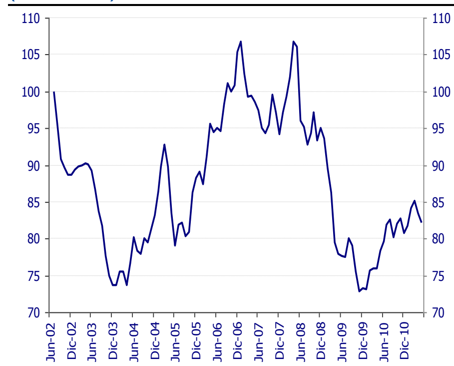
Inflation surprises continue to be slightly downward, while surprises in output are slightly upward

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.

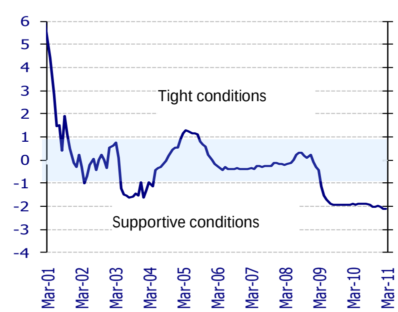
Chart 16
Activity Surprise Index
(2002=100)



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.

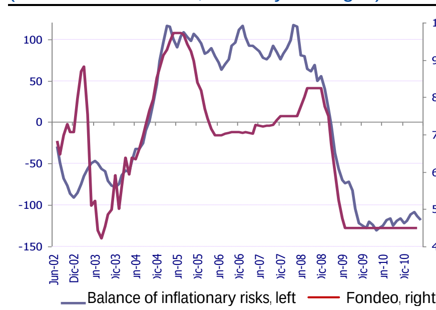
The monetary conditions have not changed and continue to be loose, although with a very slight deterioration in the balance of inflationary risks

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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