RESEARCH

Weekly Watch

Mexico

July 1, 2011

Economic Analysis

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Next week…

Will inflation again see a surprise fall?

In a week marked on the global level by the Greek Parliament's approval of new austerity measures to avoid an immediate public debt default, data released on the Mexican economy point to continued growth in the second quarter of 2011 and the moderation seen was a temporary factor. Inflation and monetary policy are again the centre of attention next week - not because there is no consensus on rates remaining the same and Banxico stressing its improvement message for the balance of inflation risks, but rather the key factor next week is discovering whether after the downward changes to inflation outlook in June made by analysts after the first fortnight, the final data will again beat us, as has been the case in recent months. With regard to Banxico, we will see how it weighs the importance of temporary versus permanent factors in price performance in the month, as well as what it says about US output. In turn, we believe a scenario where the lending rate remains at 4.5% until the second quarter of 2012 is most likely. (cont. on next page.)

Market Analysis

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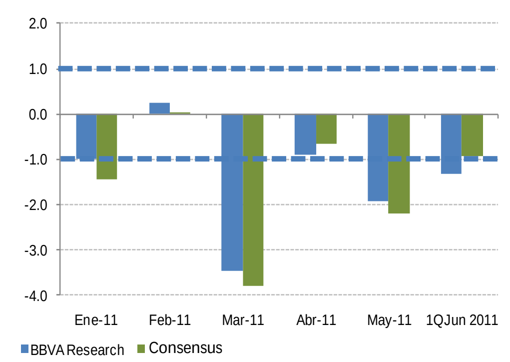
A positive week for risk assets: currency and share gains in Mexico and a rise in the domestic curve slope

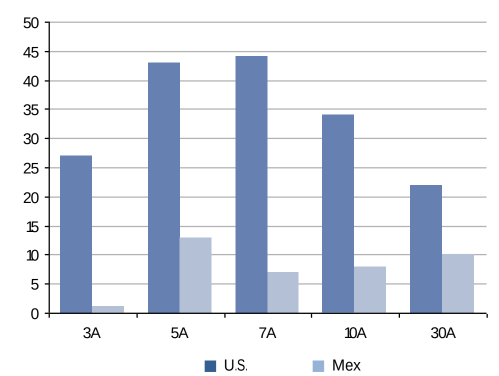
A moderation in the sovereign risk premium thanks to agreements in Greece and favorable cyclical data for the US were behind the greater appetite for risk assets. In Mexico, this led to a strengthening of the MXN and gains on the stock market. In fixed-income, the yield curve slope rose thanks to the US slope moves, but with more limited moves for local factors. With the US economic data still not final regarding the depth of its cyclical bounce, there is still space for the curve to flatten in the next 2-3 months. Meanwhile, the peso may fluctuate between 11.67 and 11.85.

Chart 1
Error in advanced monthly inflation forecast
Standardized by 1.5 standard deviations



Source: BBVA Research

Chart 2
Weekly changes in US and Mexico curve (bp)



Source: BBVA Research and Bloomberg

Economic Analysis

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Calendar: Indicators

Inflation (June, Thursday 7 July)

Forecast: -0.09% m/m (3.2% y/y)	Consensus: 0.04% m/m	Previous: -0.75% (3.25% y/y)

In the first fortnight of June, inflation again saw downward surprises driven by a stronger than expected fall in agriculture prices and services and non-food goods prices in the core component continuing to reduce the annual rate. Due to this, we forecast inflation in June to have again seen a slight contraction in the monthly rate, based on the factors above, among which the non-food goods prices could even increase the downward move in annual terms thanks to the start of summer sales in many shops and department stores. The balance of inflationary risks has improved for the rest of 2011 based on essential factors such as the stable exchange rate and lack of demand pressure.

Employment (June, over the week)

Forecast: 0.4% m/m (4.3% y/y)	Consensus: N.A.	Prev: 0.4% m/m (4.3% y/y)

Formal employment will continue to see the stable growth experienced in recent months, solely interrupted slightly by the moderation in industrial output and foreign demand in March and April due to the impact of output stoppages in Japan. We believe manufacturing and the services sector will see the higher job creation in monthly terms, while what happens with construction jobs will be especially important to providing information on the still pending sector recovery.

Monetary policy target rate (Friday 8 July)

Forecast: 4.5%	Consensus: 4.5%	Previous: 4.5%

Producer confidence (June, Friday 4 July)

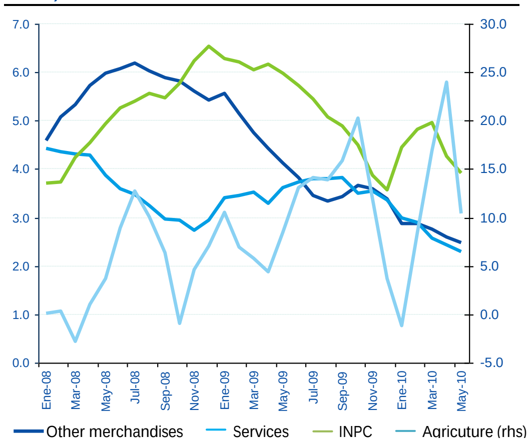
Forecast: 1.9 m/m (57.1 level)	Consensus: N.A.	Previous: 1.7% (56.1 level)

Consumer confidence (June, Tuesday 5 July)

Forecast: 1.1 m/m (90.8 level)	Consensus: N.A.	Previous: 0.8% (89.9 level)

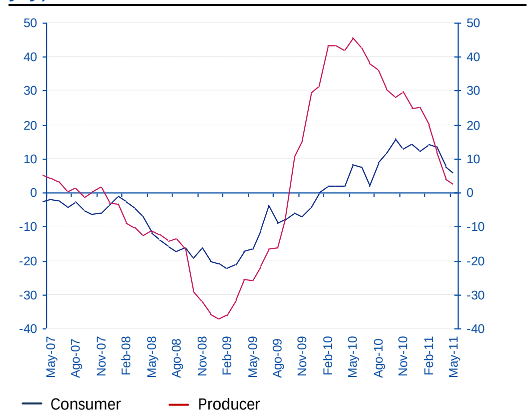
Optimism should return to manufacturers thanks to the recent performance in output data: in May, both US industrial output (0.1% m/m vs. 0.1 quarter average) and Mexican manufacturing exports (2.8% vs. 0.5% quarter average) respectively showed signs of stability and recovery. Among consumers, after the pause in March and April, we believe improving confidence will continue driven by the improvement in employment and falls in inflation, contributing to higher real wages.

Chart 3
Inflation: different subindices (% change y/y and m/m)



Source: BBVA Research with Banxico data

Chart 4
Confidence: Consumer and Producer (% change y/y)



Source: BBVA Research and INEGI

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Markets

Markets optimistic about the approval of measures in Greece and favorable economic figures in the U.S: the MXN strengthens…

The MXN saw favorable performance over the week thanks to the austerity measures approved in Greece which moderated the global risk premiums and led to a greater appetite for emerging currencies. Markets also expected German banks to agree to roll over their holdings of Greek debt. In addition, US economic data (Chicago Purchasing Manager Index and ISM) saw positive surprises, contributing to extended risk asset gains. In this context, the MXN broke through technical support levels (at 11.80 and 11.75) and stabilized around 11.62. We believe that the MXN performance over the next few weeks will show the adjustments in aversion to global risk which, given the lower risks in the EU, will focus on global economic data that continue to give no clear signs of strong activity. We do not rule out volatility continuing over the coming weeks and the MXN fluctuating between 11.67 and 11.85.

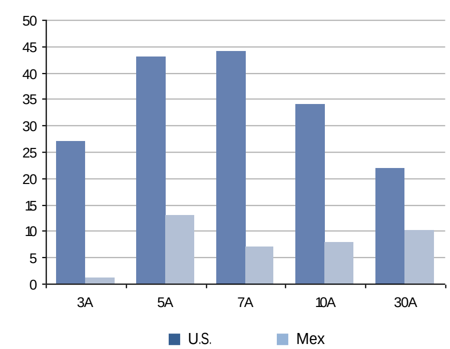
… with reductions in demand due to safe-haven assets (*Treasuries*) and increases in the Mexico curve slope…

With this weekly scenario, investors reduced demand for safe-haven assets leading to the 10-year Treasuries yield showing a major upward correction (over 30 bp) and the curve slope (2/10 year terms) increasing over 15 bp. Due to the high US curve correlation, this effect transferred to the domestic curve; however, its movements were limited, practically less than half. This performance is explained by the slopes being high and inconsistent with the domestic scenario. With the US economic data still not final regarding the depth of its cyclical bounce, there is still space for the curve to flatten in the next 2-3 months.

… and the upswing on the Mexican stock exchange being a highlight in LatAm

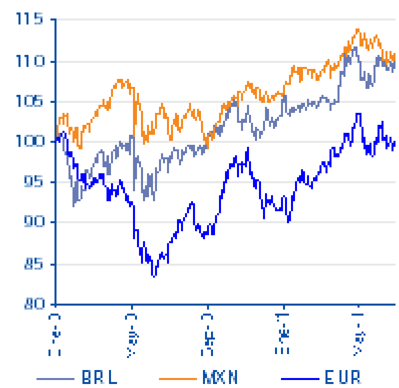
In this global scenario, all the regions posted gains, particularly (of course) Europe and to a lesser extent, the U.S. In Latin America, Mexico stood out with a weekly performance of 3.7% due to its cyclical link to the US.

Chart 5
Weekly changes in US and Mexico curve (bp)



Source: BBVA Research with data from Bloomberg

Chart 6
Relative performance of selected currencies (ppd, 01/01/10 index =100)



Source: BBVA Research with data from Bloomberg

Technical Analysis

IPC Stock Market Index

Market Analysis
Equities

Technical Analysis
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Source: BBVA, Bancomer, Bloomberg

IPC:. After a bounce of just over 2,200pts, the IPC stock market is already recording high over-purchase levels in short-term oscillators and hits the 2nd standard deviation in 30- and 60-day regressions. These technical conditions are also being seen at several IPC issuers. This suggests that we could start to see profit-taking near the 37,000pts resistance level. The high transaction levels seen over the week points to any adjustment being a new opportunity to take positions. The level we could take as an entry point would be 36,000pts.

Previous recommendation: The 10-day rolling average is about to move up and break through the 30-day. This leaves us with the perspective of a move in the IPC toward the 36,000pts or even the 36,240pts zone where the 200-day rolling average comes in.

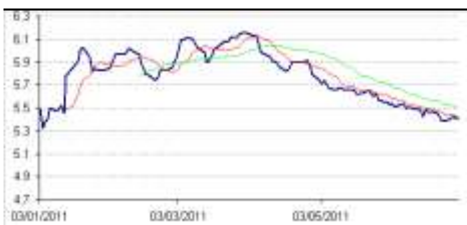
MXN

Source: BBVA, Bancomer, Bloomberg

The dollar continued a strong downward trend over the week, breaking the 10- and 30-day rolling averages and the P$11.80 level where it had found a floor. With this, the move may extend toward the P$11.60/11.55 zone where we believe it may start to stabilize.

Previous rec.: We believe that it could extend toward P$12.00, although we do not think it could exceed this zone since it will come with high over-purchase readings.

3Y M BOND



Source: BBVA, Bancomer, Bloomberg

3Y M BOND (yield): Side move over the week. It has not managed to come in above the 10- and 30-day rolling averages and we maintain it will only see a trend change when it bounces up 5.5%.

Previous rec.: Change in trend with a bounce above 5.6%.

10Y M BOND

Source: BBVA, Bancomer, Bloomberg

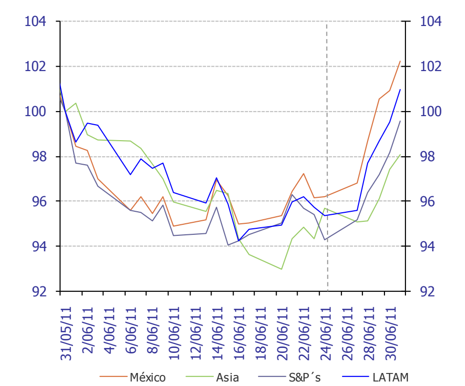
10Y M BOND (yield): Respecting the 6.9% floor where it starts a bounce. It has come in slightly above the 10- and 30-day rolling averages, meaning a possible move toward 7.1% and 7.2%.

Previous rec.: If the 6.9% support is broken downward, it may accelerate down to the next floor at 6.75%.

Markets

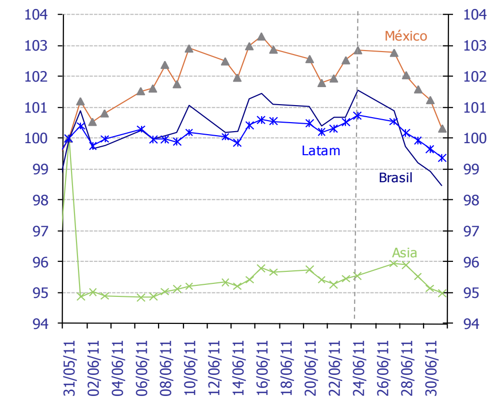
General upswing on stock markets and currency strengthening over the week after Greece passes the first part of its austerity program and US manufacturing data came in above expectations

Chart 7
Stock Markets: MSCI Indices (May 31, 2011 index = 100)



Source: Bloomberg & BBVA Research

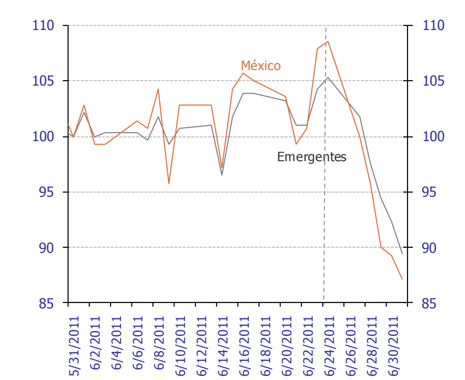
Chart 8
Foreign exchange: dollar exchange rates (May 31, 2011 index = 100)



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

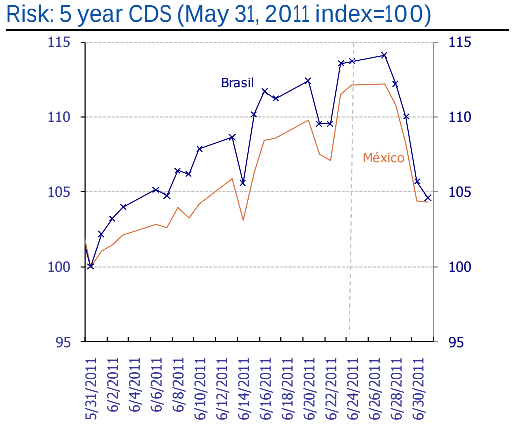
Fall in risk aversion after Greece approves its austerity plan in the week and US housing and manufacturing data support the idea that the recovery rate should increase in the second half of 2011.

Chart 9
Risk: EMBI+ (May 31, 2011 index = 100)



Source: Bloomberg & BBVA Research

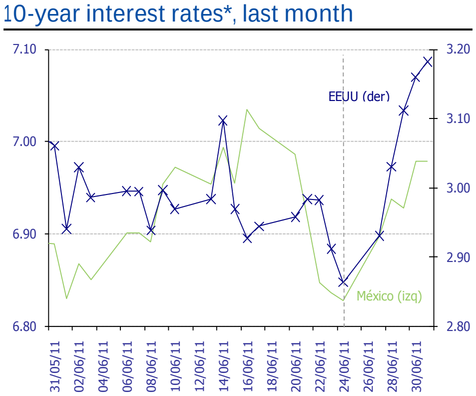
Chart 10
Risk: 5 year CDS (May 31, 2011 index=100)



Source: Bloomberg & BBVA Research

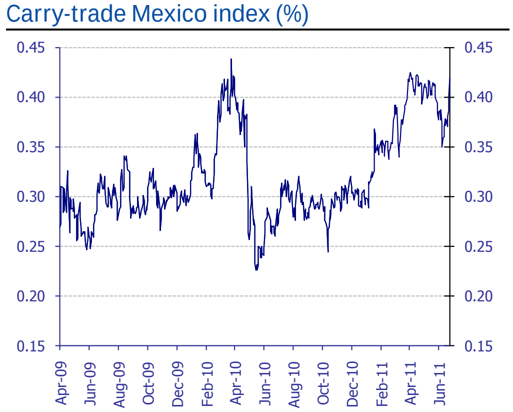
Fall in US rates in light of fall in global risk aversion. Rates in Mexico record an upswing over the week.

Chart 11
10-year interest rates*, last month



Source: Bloomberg & BBVA Research

Chart 12
Carry-trade Mexico index (%)

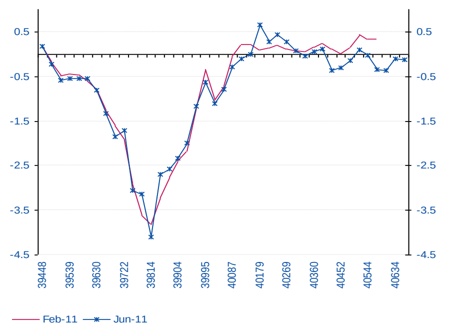


Source: BBVA Research with data from Bloomberg

Activity, inflation, monetary conditions

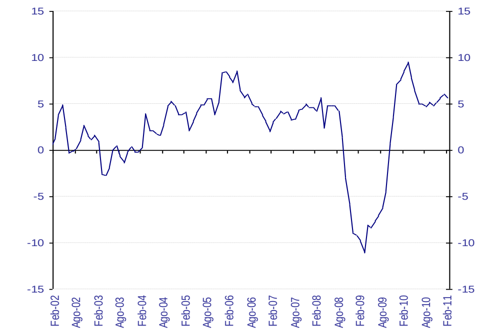
For the time being, recent output data point to moderation in April being temporary linked to industrial output

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.

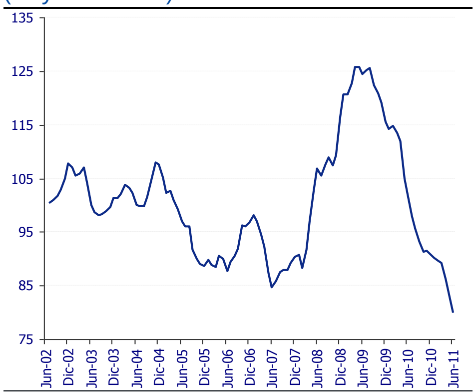
Chart 14
Advance Indicator of Activity (% change)



Source: INEGI

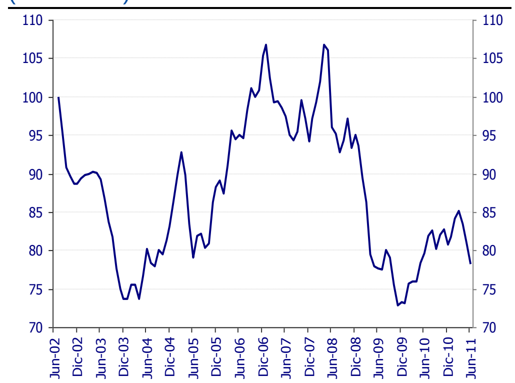
Recent inflationary surprises have been downward, while those concerning output have been mixed.

Chart 15
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.

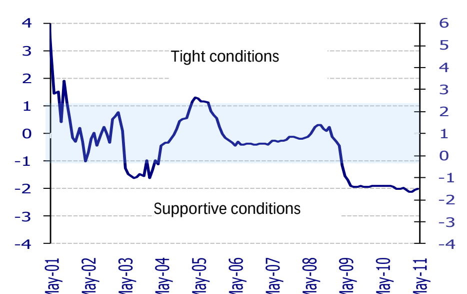
Chart 16
Activity Surprise Index (2002=100)



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.

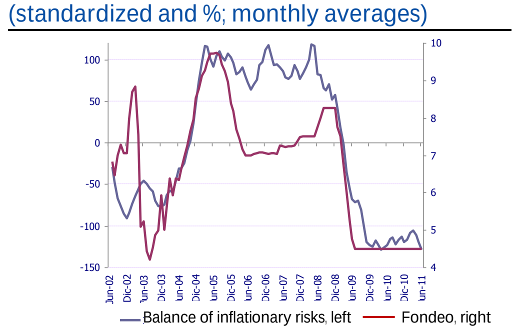
The monetary conditions have not changed and continue to be loose, with this loosening in fact increasing slightly in recent days.

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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