

# Weekly Watch

Mexico

## Next week...

### July Inflation and Quarterly Inflation Report.

Next week sees the release of July inflation figures which we expect to see an increase of 0.57% m/m (3.64% y/y). This slight upswing in inflation should mainly be down to non-core factors, specifically agricultural product prices. We estimate core inflation to see a 0.29% increase m/m and remain steady around 3.2% y/y thanks to slack on factor markets meaning demand avoids placing pressure on prices. Therefore, we repeat our forecast for inflation to close the year around 3.6%, without ruling out the existence of some upward risks such as an increase in commodity prices or fluctuations in agricultural product prices due to weather conditions. With regard to the second quarter Banxico Inflation Report, special attention will need to be paid to the domestic output analysis, especially for coming months. This in view of the lower growth rate in recent months and downward revision to US output. We expect the proposed inflation scenario to be very similar to the last quarter and a mention of an improvement to the balance of risks in the face of economic moderation. Based on this, we do not expect major changes to monetary policy.

### Upturn in cyclical risk aversion in the U.S., despite the fiscal and debt agreements. Uncertainty to continue

Major falls in risk assets in the face of uncertainty regarding the extent of U.S. slowdown. MXN with high weekly volatility, trading at 12.00 (vs. 11.73 at the start of the week) and with a fall in the IPC stock exchange of around 7%. The markets were focused on non-farm payroll data at the end of the week which did not support the pessimism over previous days. However, rumors of a US downgrade from S&P sparked fear. The bond markets saw a major downward move in the US curve and gains in domestic bonds. Given the current monetary stance, we believe that current levels are at lower limits.

August 5, 2011

#### Economic Analysis

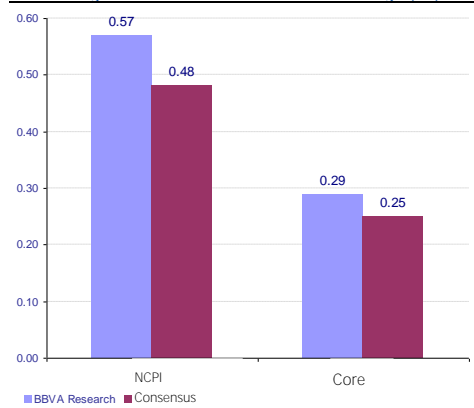
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#### Market Analysis

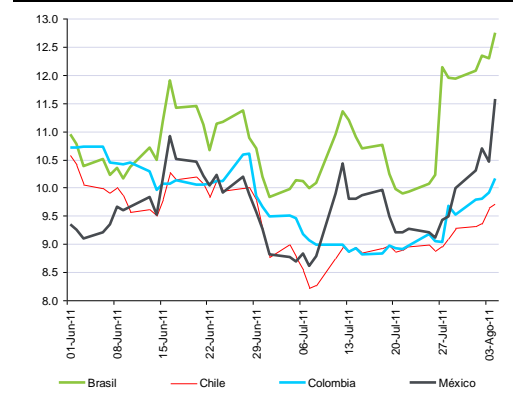
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Chart 1  
Monthly inflation forecast for July (%)



Source: BBVA Research with Banamex Survey data

Chart 2  
Currencies: 1m implied volatility



Source: BBVA Research with data from Bloomberg

## Calendar: Indicators

### Economic Analysis

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#### Industrial Output (June, August 11)

Forecast: 0.0% m/m (4.8)      Consensus: N.A.      Previous: 1.1% m/m (4.4)

This week, industrial output performance for last June will be released. It should be stated that after the pause in the recovery over previous months, May saw positive surprises with 1.1% growth over April, although mainly linked with a bounce in the automotive sector (11.3% m/m, -1.7% m/m on average for the previous three months), the improvement also included other manufacturing sectors such as machinery and equipment, and metal products

For June, according to AMIA data around 9% more automotive units were produced over June last year although nearly (-)2.7% less than the previous month. These automotive industry results alongside the slow improvement in the construction industry lead us to forecast total manufacturing to have remained almost unchanged over May, meaning annual growth of around 4.8% (seasonally adjusted).

#### Structural Indicators for Occupation and Employment (2Q11, August 12)

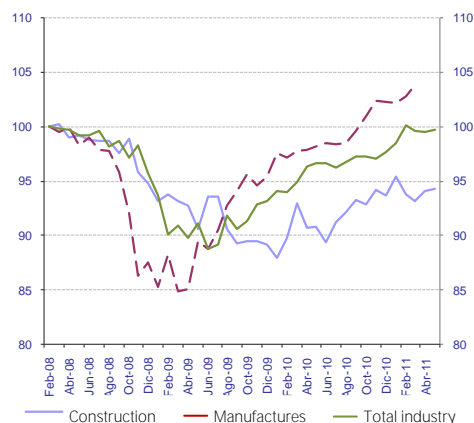
##### Unemployment rate

Forecast: 5.5%      Consensus: N.A.      Previous: 5.1%

Friday sees the release of employment performance in the second quarter of the year. Structural employment indicators will be important since they will provide a wider overview of the features of jobs created during the second quarter. Another major factor is the release of data based on expansion factors adjusted to final data from the Population and Housing Census 2010.

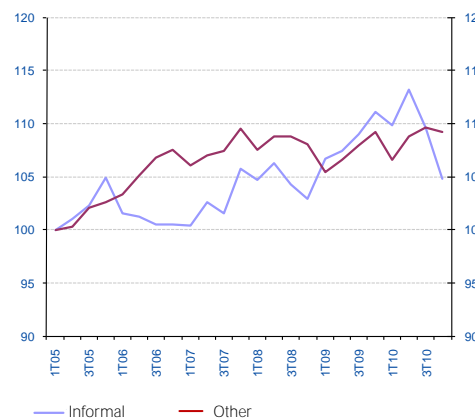
Knowing performance in the second quarter for indicators such as employment, under-employment, employment in critical conditions, the evolution in informal employment as well as population based on income level will be important to see the strength of the recovery. It should be stated that until present, the low salary level for new jobs has been one of the main weaknesses behind the recovery in household spending. We expect the unemployment rate to come in around 5.5% of the population (seasonally adjusted), above the 5.1% average in the 1Q11.

Chart 3  
Industries: Construction and Manufacturing  
(100 at cycle maximum)



Source: BBVA Research with INEGI data

Chart 4  
Employment: Informal and Other (1Q05=100)



Source: BBVA Research and INEGI

## Markets

Global markets value what the level of economic adjustment in the U.S. will be; rising cyclical risks specifically affect Mexico

Although the fiscal and debt agreements in the U.S., together with good manufacturing figures (PMI) from China, put a positive bias on the start of last week, there was more risk aversion in the markets due to the greater than expected risk of an economic slowdown in the U.S. (disappointing GDP and manufacturing data); in addition, higher weekly adjustments were seen in Mexico due to its exposure to the US economy; the MXN saw increased volatility and trades up to 12.00 compared with 11.73 at the start of the week. The currency may continue extremely volatile within this broad corridor in response to economic news from the U.S.

### Market Analysis

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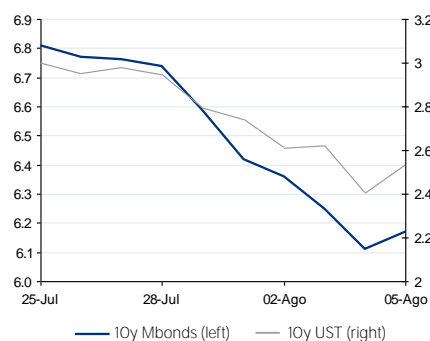
### Major downward move in the US curve leading to gains in domestic bonds...

The increased cyclical uncertainty in the US and risk premiums for the European debt crisis (spreading to Italy and Spain) led to a higher appetite for debt curves which led to a major downward move in the US debt curve (the 10 year managed a major rally to 45bp since July 28). In line with this move, domestic bonds saw gains (although they partly reversed at the end of the week after the release of US job data). Given the current monetary pause, we believe that current levels are at lower limits. Therefore, there should be no further support although the current global scenario limits such a strong bounce as that seen last year.

### ...and the Stock Market sees a major downward weekly adjustment despite corporate earnings

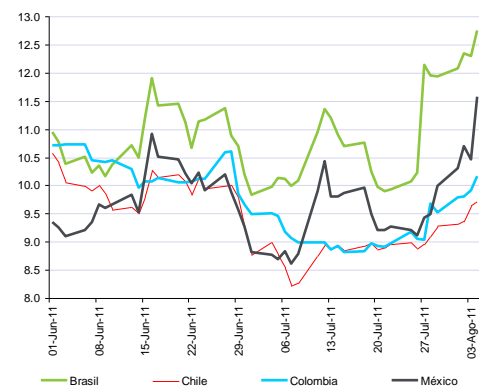
Global markets continue to be affected by the cyclical and sovereign balance of risks despite better-than-expected corporate earnings in the US and Mexico. In the US, with nearly 80% of company reports in, the level of positive surprises in EPS and sales comes in around 60%. Until the present, companies are seeing growth of 11.9% and 17.2% in sales and EPS respectively. Figures are 1.8% and 4.7% better than the consensus. In Mexico, after reports from Gmexico and Pe&oles, final growth was 12.5% in sales, 9.7% in EBITDA and -10.2% in net earnings, recalling that removing the sale of beer assets by Femsa the previous year, growth in net earnings came in at almost 40%. Earnings are, at the end of the season, 2.6% higher in sales, 1.9% better in EBITDA and 3.9% higher than expected in Net Earnings compared with our estimates. Despite this, falls in the IPC stock market (around -7% over the week) are down to doubts on US growth and the ability of the authorities to put counter-cyclical policies into effect.

Chart 5  
Yield change in 10-year UST and Mbonds (%)



Source: BBVA Research with data from Bloomberg

Chart 6  
Currencies: 1m implied volatility



Source: BBVA Research with data from Bloomberg

Market Analysis  
Equities

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## Technical Analysis IPC Stock Market Index



IPC: The week's move took short-term technical indicators to extremely high overselling zones for Mexico and the US. Only a few IPC issuers are not seeing a short-term buy opportunity. We believe that these forward conditions in the negative movement should lead to a technical bounce or a pull-back that discounts some of the weekly decline. The target levels we could consider for this move come in at 34,300pts and 34,700pts.

Previous rec.: With this break, the IPC should come in at its next resistance level of 36,600pts, where the 200-day rolling average sits. We see the first support at the 10-day rolling average over 35,660pts.

Source: BBVA, Bancomer, Bloomberg

## MXN

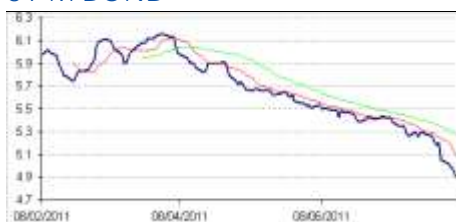


The dollar moves up through the MXN 11.80 resistance and hits the next resistance zone around MXN 12.00. Signs of over-buying in the oscillating indicators, as well as the psychological level and 200-day rolling average should make breaking this zone difficult and favor a return to the first support now at MXN 11.80.

Previous rec.: The break of P\$11.80 could place the next resistance at P\$11.90 and P\$12.00.

Source: BBVA, Bancomer, Bloomberg

## 3Y M BOND



3Y M BOND: (yield): Major fall over the week leads to high over-selling. Support at 4.8% and resistances at 5.07 and 5.26%. Likely to see a short-term bounce.

Previous rec.: Due to such high over-selling, it should see an upward bounce towards 5.25% again to the high part of the range.

Source: BBVA, Bancomer, Bloomberg

## 10Y M BOND



10Y M BOND (yield): Fall breaking the negative range base to fall near the 6% floor. Upturn toward resistances at 6.5 and 6.77%.

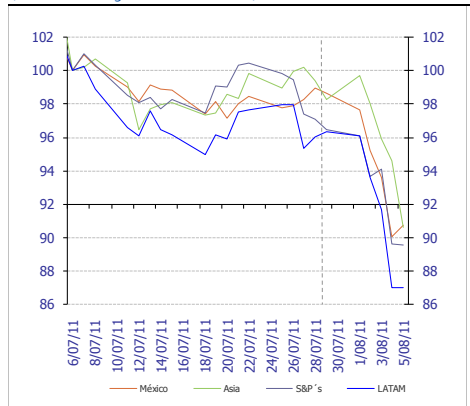
Previous rec.: We can expect a limited bounce to 6.88%. Only above this level does it start to set a change in the trend.

Source: BBVA, Bancomer, Bloomberg

**Markets**

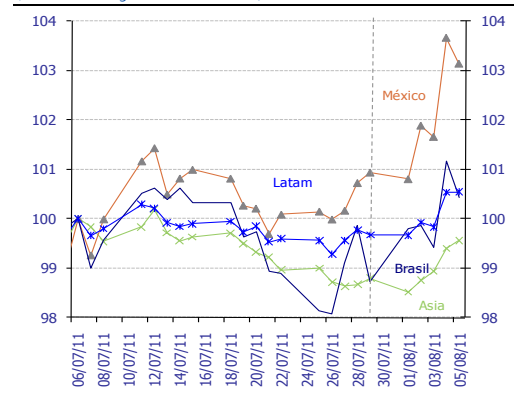
Personal spending and manufacturing output data in the US below expectations lead to declines on stock markets over the week, as well as a lower peso. Slight above-expectations US job data and an announcement on debt reduction in Italy halt falls at the end of the week

Chart 7  
Stock Markets: MSCI Indices  
(Index, July 6, 2011=100)



Source: Bloomberg & BBVA Research

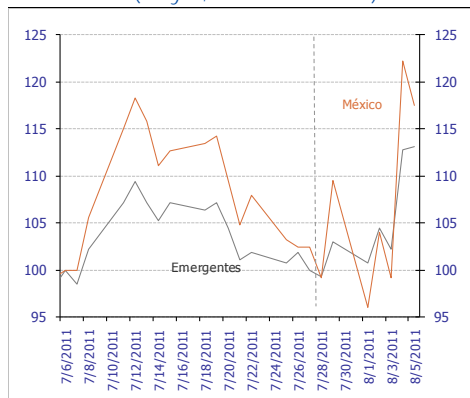
Chart 8  
Foreign exchange: dollar exchange rates  
(Index, July 6, 2011=100)



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

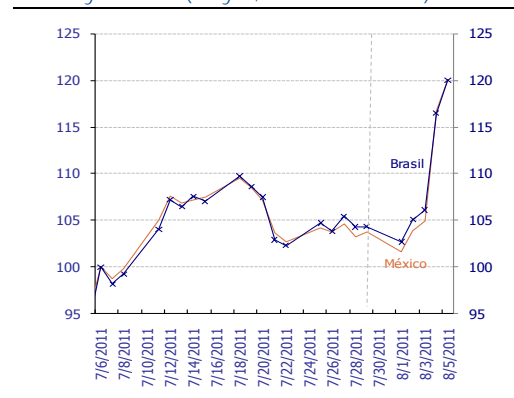
Increase in risk aversion after US data release pointing to a doubtful recovery. The possible downgrade in US debt and the debt problems in Europe increase volatility

Chart 9  
Risk: EMBI+ (July 6, 2011 index=100)



Source: Bloomberg & BBVA Research

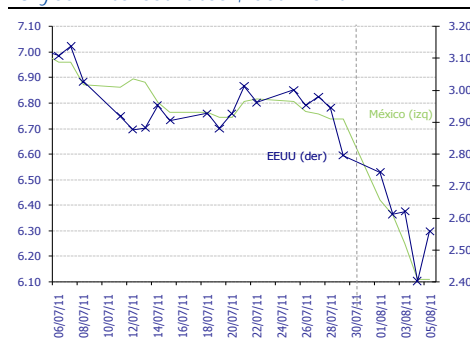
Chart 10  
Risk: 5 year CDS (July 6, 2011 index=100)



Source: Bloomberg & BBVA Research

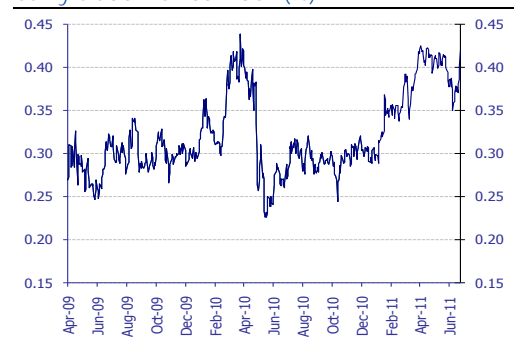
Fall in U.S. rates in the face of demand for safe-haven assets (flight to quality). Rates in Mexico dominated by correlation with US T-Bills

Chart 11  
10-year interest rates\*, last month



Source: Bloomberg & BBVA Research

Chart 12  
Carry-trade Mexico index (%)

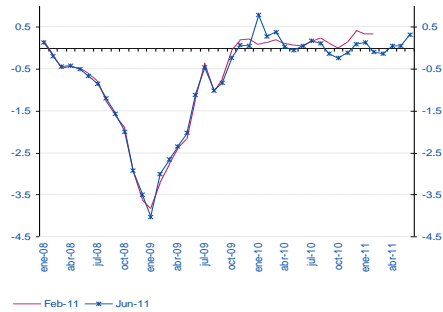


Source: BBVA Research with data from Bloomberg

## Activity, inflation, monetary conditions

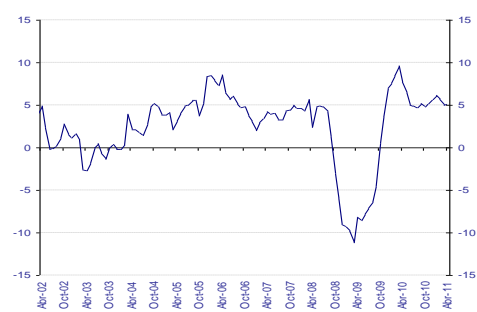
For the time being, recent output data point to moderation in April being temporary and linked to industrial output

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.

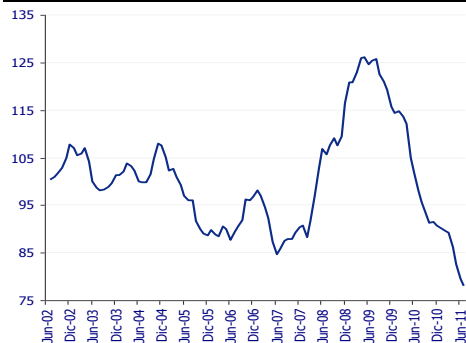
Chart 14  
Advance Indicator of Activity (% change y/y)



Source: INEGI

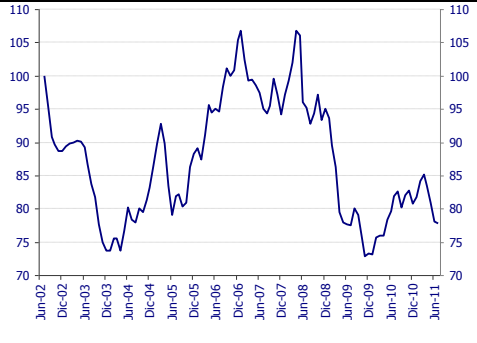
Recent inflationary surprises have been downward, while those concerning economic activity have been mixed.

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.

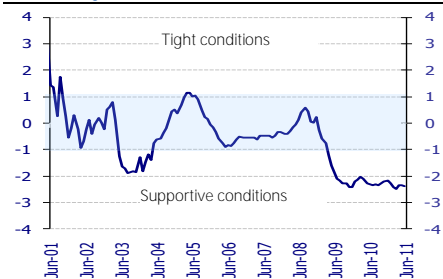
Chart 16  
Activity Surprise Index (2002=100)



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.

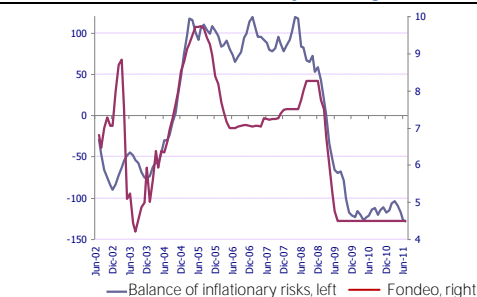
The monetary conditions have not changed and continue to be loose, with this loosening in fact increasing slightly in recent days.

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 likelihood of monetary restriction

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