BBVA Research

Mexico, revision of the economic scenario:

Lower growth without relevant inflation pressures and sound macro policies to anchor financial variables evolution

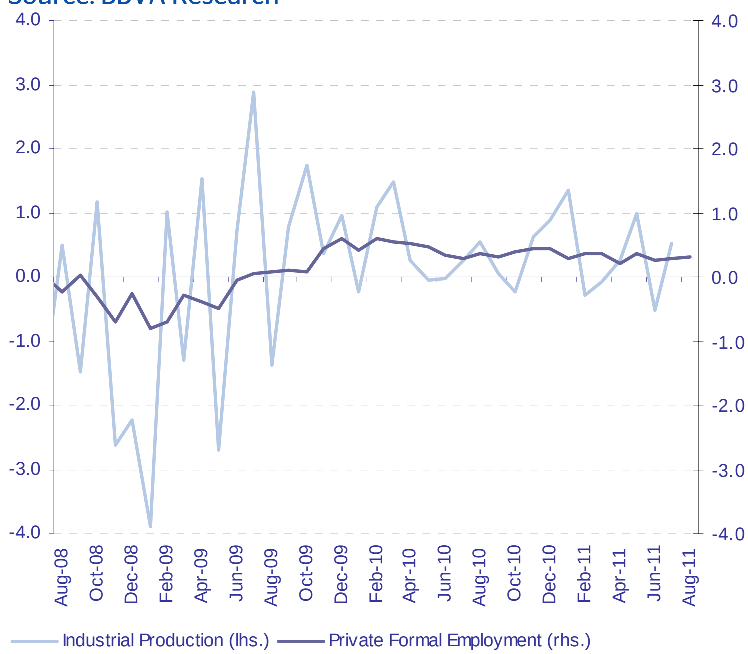
México DF, September 21st 2011

Up to date, Mexican economic data are resilient to global environment

- **Most relevant economic indicators (July's Industrial Activity, August's Formal Employment) retain their previous positive trends.**

Industrial Production & Formal Employment (mom%)

Source: BBVA Research



Mexico

Source: BBVA Research, INEGI, STPS

Indicator	Evaluation Q1-2011	Evaluation Q2-2011	Evaluation Q3-2011	Jun-11	Jul-11	Ago-11
Confidence (Cons.)	Below	In line	In line	In line	In line	In line
Retail Sales	In line	In line	In line	In line	In line	
Automobile Prod.	Below	In line	In line	In line	Below	
CPI	Below	Below	In line	In line	In line	In line
Confidence (Prod.)	Below	In line	Below	In line	In line	Below
Industrial Production	Below	In line	In line	In line	In line	
Exports (Manuf)	In line	In line	In line	In line	In line	
Private Employment	In line	In line	In line	In line	In line	In line
Unemployment Rate	Above	Above	In line	Above	In line	

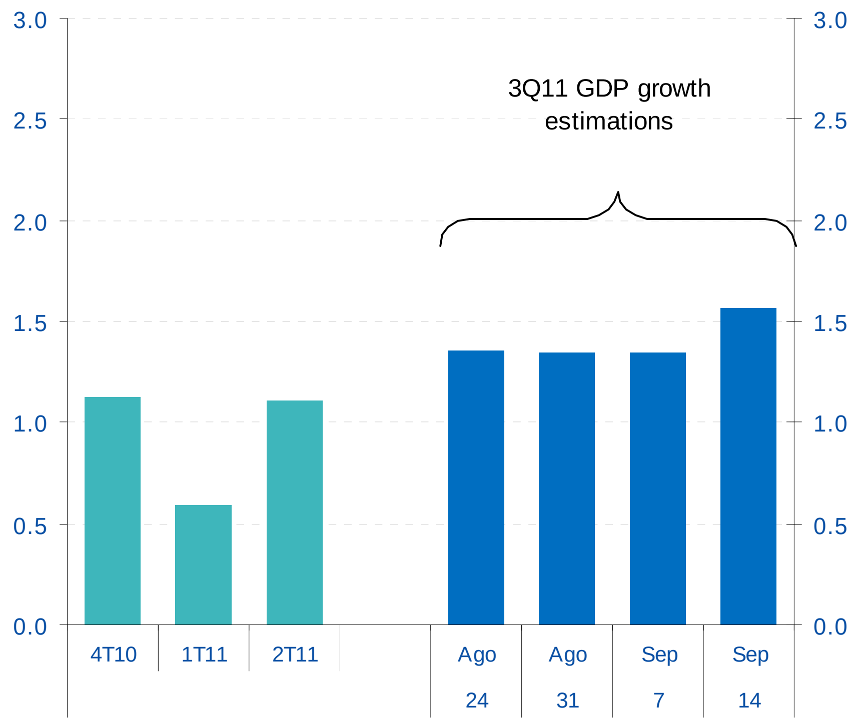
Up to date, Mexican economic data are resilient to global environment

- All in all, GDP growth could maintain during 3Q11 its previous q/q rhythm of variation (1.3%, +/- 0.3 pp)
- Regarding the whole year, even considering low range for 3Q11 and 4Q11 deceleration to the lowest level of 2011, GDP could growth 3.8%.

Mexico, 3Q11 GDP Real-Time forecast

Based on MICA-BBVA Model, %, q/q, sa

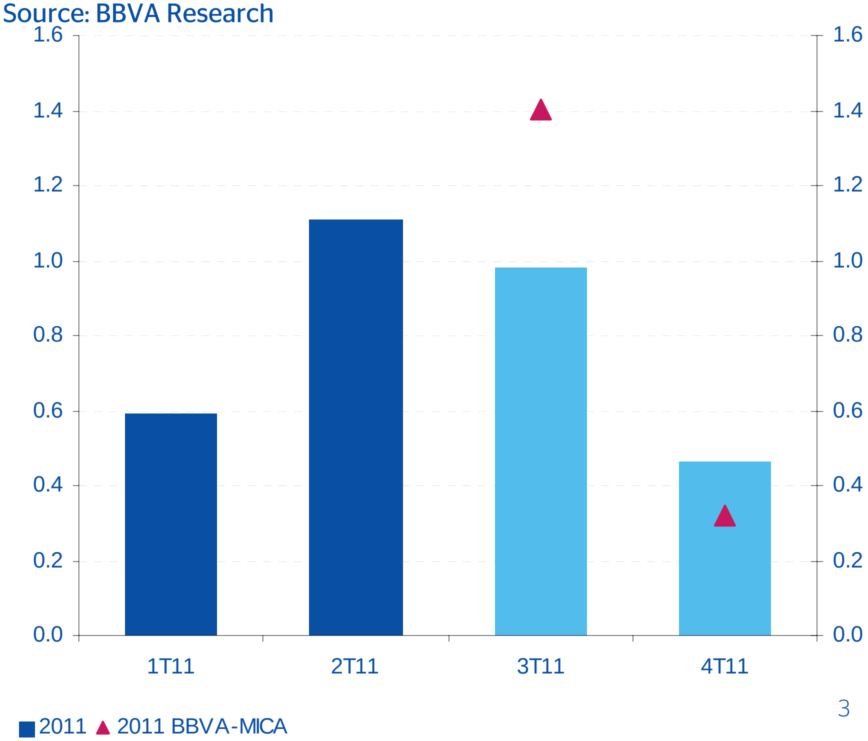
Source: BBVA Research



Mexico, 2011 GDP Growth

%, q/q

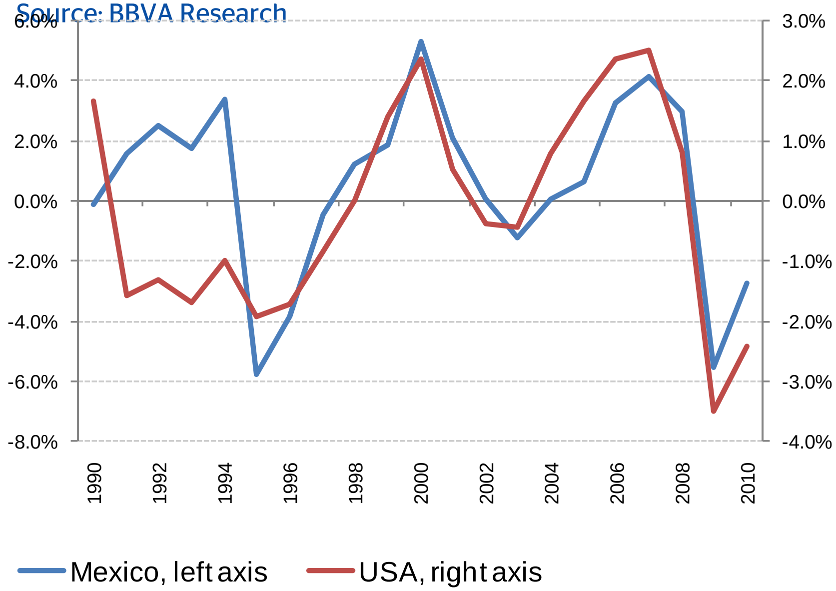
Source: BBVA Research



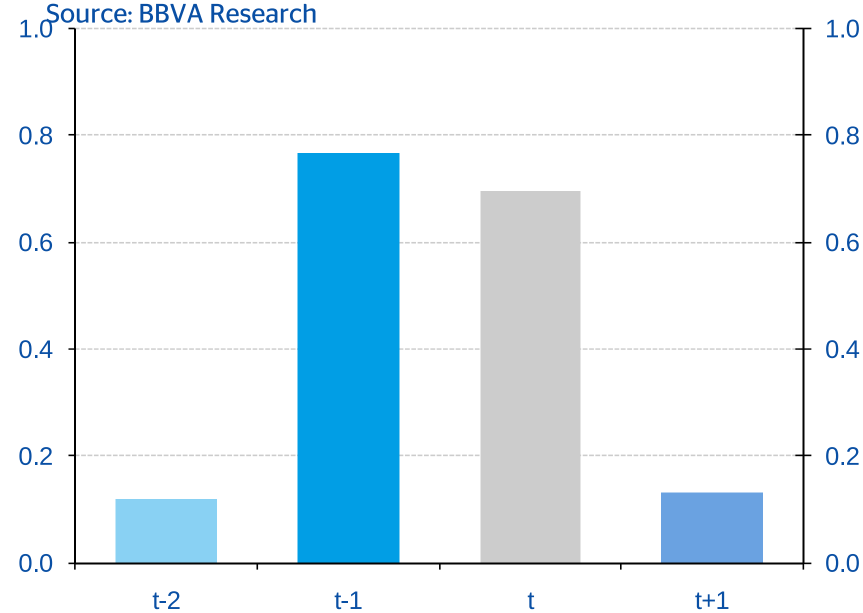
2012: GDP growth from 3.8% to 3.3%.

- USA's amended expectations for 2011&12 impacts on Mexican economy through lower exports, activity and, finally, employment and income. However:
  - i) improved competitiveness should mitigate negative impact;
  - ii) higher public expenditure during election periods should be a positive factor in 2011&12;
  - iii) inflation anchorage, limited financial stress and funding availability should give resilience to private domestic demand

Mexico and US Cyclical Relationship, Output gap (GDP gap to Potential GDP)
%
Source: BBVA Research

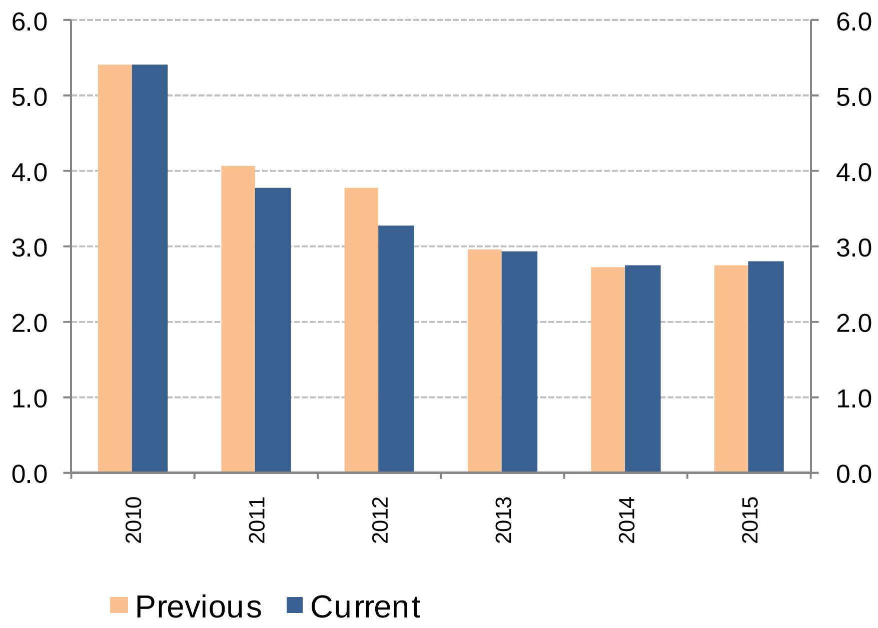


Mexico, Public Expenditure during Presidential Election periods
2000&2006 Average
Contribution to GDP growth, pp
Source: BBVA Research



Beyond 2012: without major changes regarding previous scenario

Mexico, GDP growth
%, y/y
Source: BBVA Research



- Factors behind mid-term scenario have not changed:
  - Moderated US economic growth, positive view on Mexican competitiveness
  - Commitment of economic policies with nominal stability
  - Lack of excesses in foreign or domestic disequilibrium (current account or public deficit)

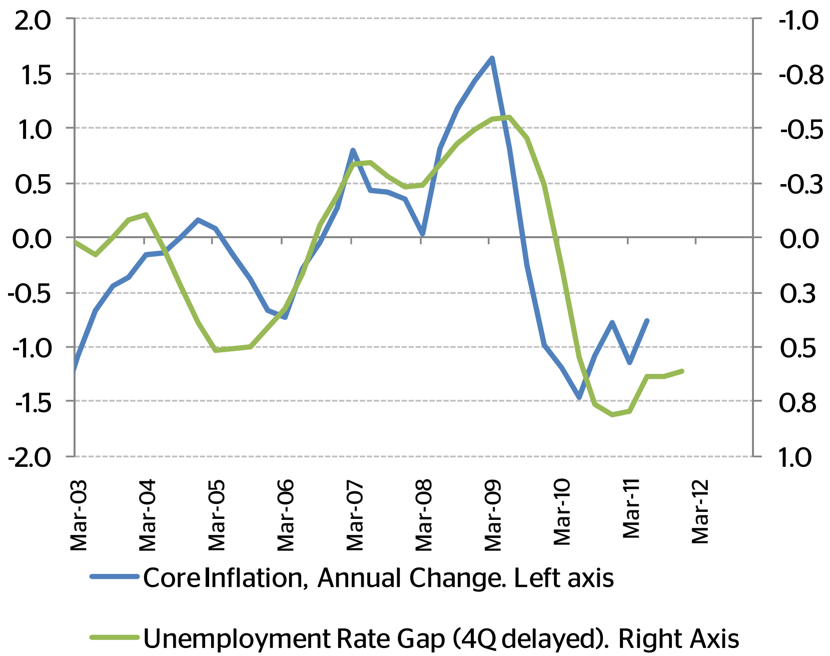
Inflation: it shouldn't be an issue by the lack of demand pressures

- Downward surprises on non-core component and resources availability to fulfill demand evolution (low pricing power of businesses) maintain inflation at very low levels.
- During 2012 the inflation profile will be dependent on seasonal factors but its core trend will remain roughly stable around 3.0-3.2%.

Inflation and Demand Pressures

Core inflation annual change and Unemployment gap

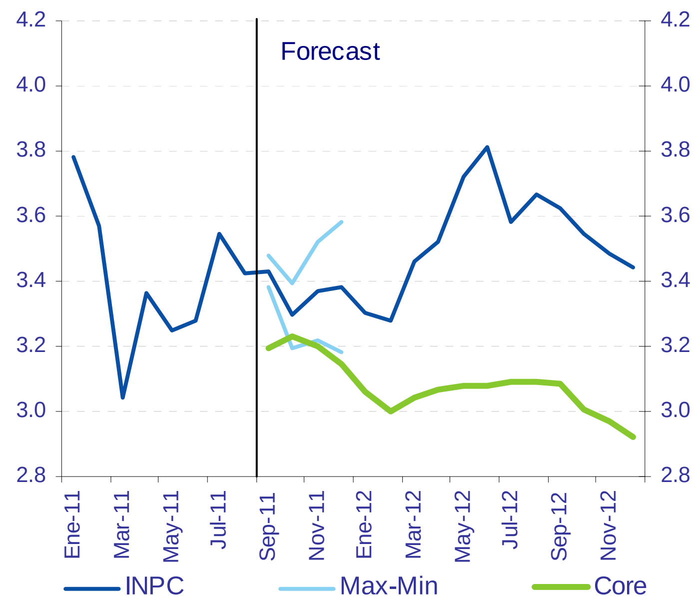
Source: BBVA Research



Mexico, inflation

%, y/y CPI

Source: BBVA Research

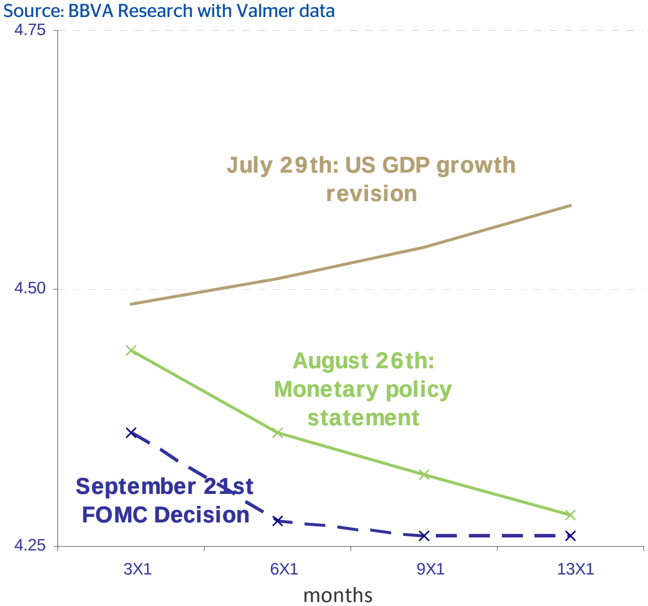


Banxico: monetary pause beyond 2012 with an earlier cut bias

- **Last month a deep change on Fondeo's perspectives happened following global cycle weaknesses, downward surprises on domestic inflation and, last but not least, Banxico's communication tone changed from hawkish bias to neutral.**
- Two opposite positions in Banxico's board:
  1. Costs associated with giving an easing signal considering that inflation expectations are anchored at levels above 3%: it could be interpreted as a lack of compromise with price stability
  2. "There are costs associated with a more restrictive monetary policy stance than the one that is necessary to meet the inflation target".
- **Altogether, we expect a monetary pause beyond 2012 with a bias to an early Fondeo cut regarding a further impairment of economic scenario or excessive tightening of domestic monetary conditions.**

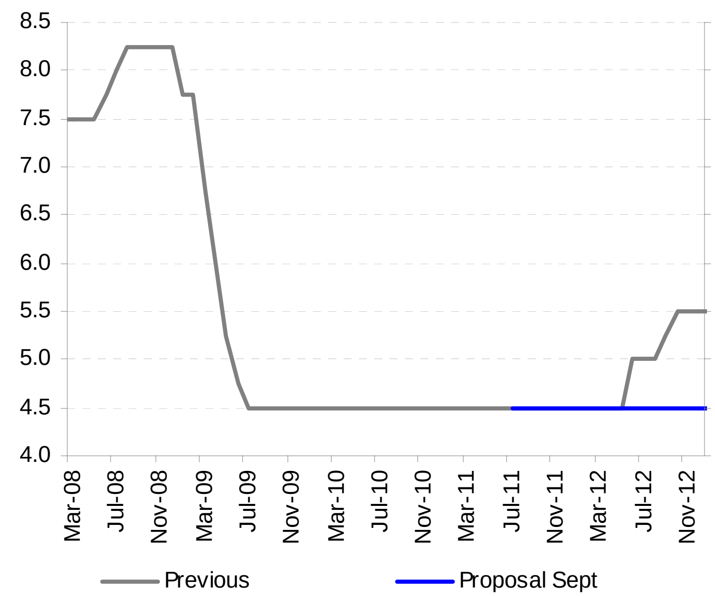
IRS Swap curve, Fondeo implicit rate

Source: BBVA Research with Valmer data



Fondeo Rate (%)

Source BBVA Research

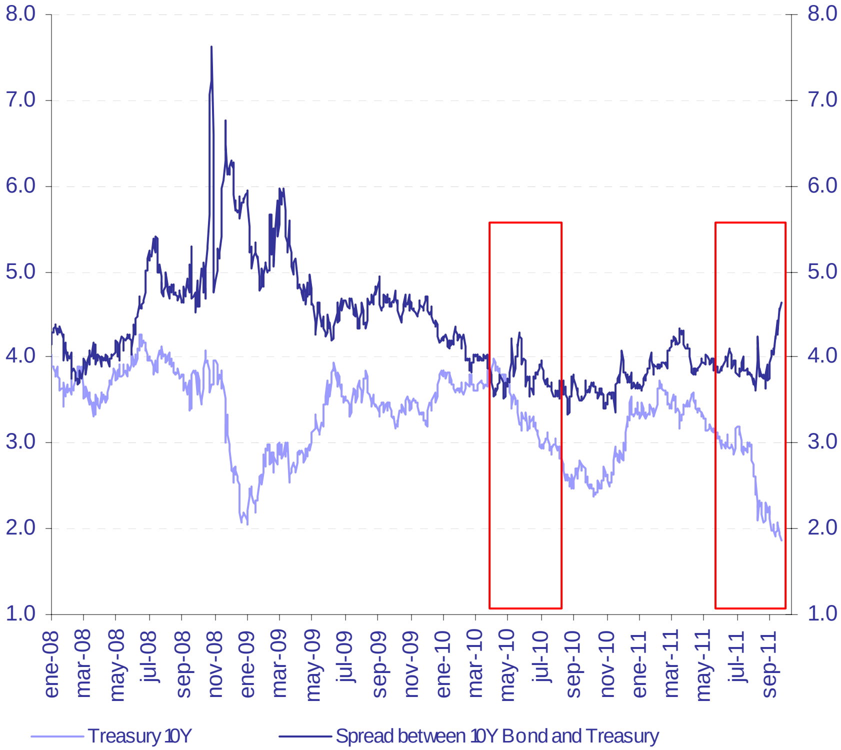


Financial volatility: limited impact regarding the support of sound macro policies

- Episodes of global risk aversion on Mexican bonds or exchange rate have been short-lived since the beginning of 2010

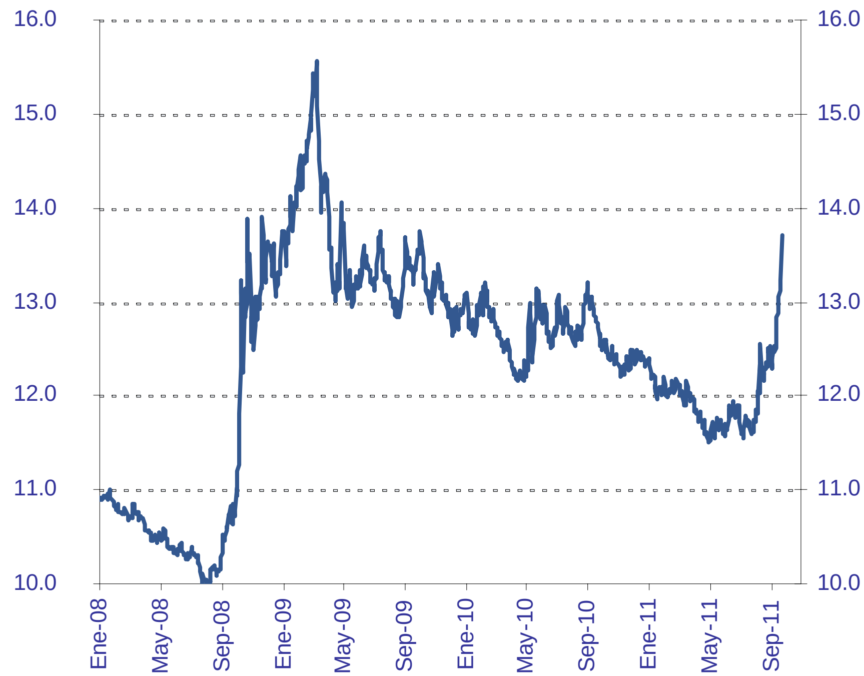
Spread between the 10Y Mexican Bond and the 10Y Treasury note

Source: BBVA Research and Bloomberg



Exchange rate (ppd)

Source: BBVA Research & Bloomberg

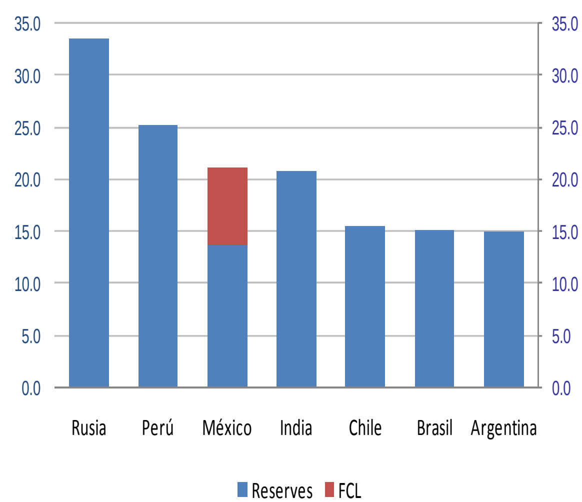


Strong commitment with sound macro policies enhances creditworthiness, it should dampen volatility

- Non-external imbalances and reliable fiscal policy allow Mexico be supported by IMF through FCL, precautionary USD funding without policy conditionality
- Low debt levels and adequate international reserves have contributed to keep a relatively low credit risk
- If the global risk hikes again, in order to limit sensibility to the upside, the anchorage of debt and deficit to their objectives will be key.

Availability of USD funding (%GDP)

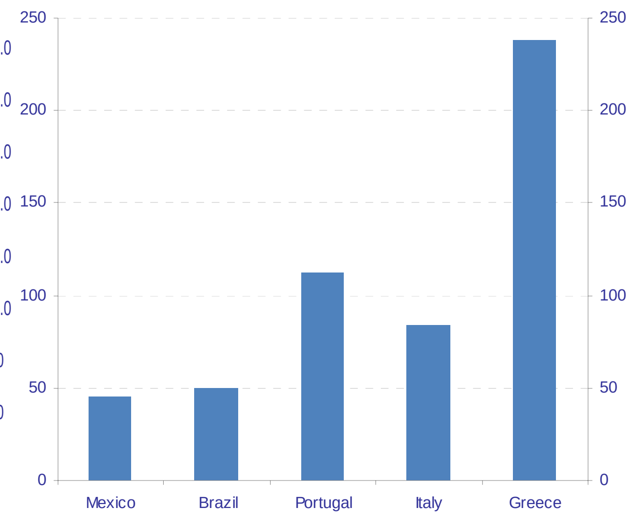
Source: IMF and BBVA Research



Change in CDS, %

Jan11 – Sept11

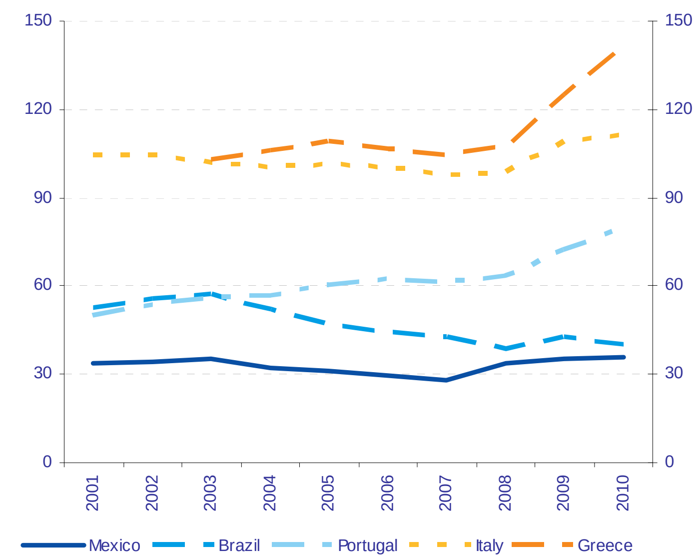
Source: BBVA Research and Bloomberg



Public Debt

% of GDP

Source: BBVA Research, IMF and Mexican Treasury



Main Messages

- Fresh data: until July & August, any relevant deceleration in activity, domestic expenditure or formal employment. Current estimation for 3Q11 is 1.3% q/q (2Q11=1.1%). All in all, considering USA 2H11 slight resume of growth and no changes in the lack of fundamental reasons to exposure to global stress, we guess 3.8% GDP growth in 2011 (-0.3 pp vs 4.1% forecasted last July).

- Regarding 2012 and USA revision: downward revision from 3.8% to a 3.3% (-0.5 pp). It is a small revision considering the historical correlations between USA and Mexico growth and the USA's correction, but we take into account some supportive factors:
    1. Lack of exposure to Europe, narrow contagion channels even in the financial sector.
    2. Positive factors regarding our tight relationship with USA economy: competitiveness improvement.
    3. Supportive financial conditions, sound financial system is able to fulfill loan's demand.
    4. Public demand boosted by electoral cycle during 2011 and 1H12

- Inflation and monetary policy: inflation shouldn't be a concern in the forecast horizon given the domestic and global environment, Monetary policy will respond with a longer monetary pause, beyond 2012. Uncertainty is biased to an early cut (50 bp) at the end of 2011 if economic environment deteriorates and/or changes on global monetary policies tighten relative Banxico's policy. Banxico's mood not in favor of "too much activism on rates" weights against an early cut.

- Yield curve and exchange rate: soundness of the domestic macro policies and looking for profitability given by protracted abundance of global liquidity should anchor yields of public debt assets and exchange rate in front of potential episodes of global risk premium. Perception of policymaker's strong commitment with fiscal consolidation and inflation stability is a key assumption.

- Beyond 2012 : apart from negative base effect in 2013 due to post-electoral public demand adjustment, it should be a convergence to long-term capability of growth (2.7%-3.0%, our current estimation of potential GDP growth without deep reform process). Commitment with sound fiscal and monetary policies will be maintained.

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