BBVA | RESEARCH

Weekly Watch

Mexico

September 30, 2011

Economic Analysis

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Market Analysis

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Next week...

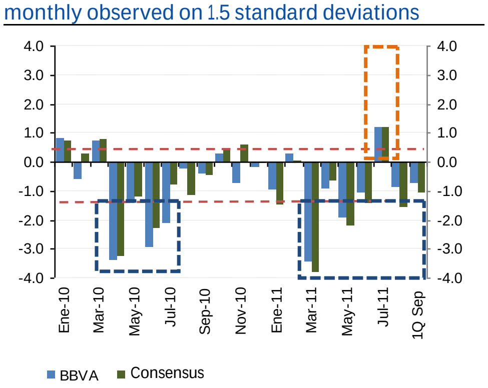
... closing the third quarter of the year

The coming week will see the first clues as to how the Mexican economy and, especially, formal employment may be affected by a highly volatile and uncertain global financial scenario in response to the weakness in output and doubts as to the direction of US economic policy and the euro area. Not only will we see the performance of formal employment in September, where we expect to see an increase of 0.28% in the month, but also (and for the same month) consumer and manufacturing sector confidence indicators. With regard to inflation, figures for September will be released which should not be important for financial markets already used to downward surprises in consensus forecasts. As long as the surprise is not higher than usual for recent months since it is the last inflation figure before the Banxico monetary policy decision next Friday, October 14, we maintain our forecast that Banxico will leave the Lending rate unchanged at 4.5%.

Short-lived short-term rally, sovereign uncertainty remains.

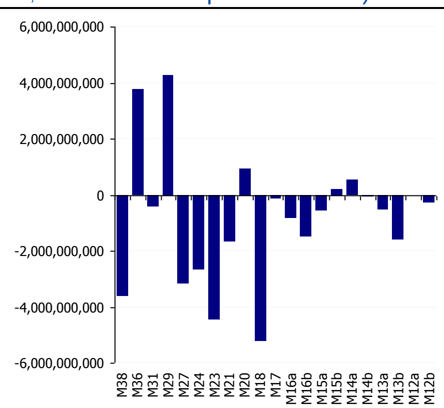
Market vigilance was seen clearly at the end of the week, still expecting a full solution to European sovereign risk and where signs on the cycle continue to increase volatility. This time around, weak retail sales figures in Germany and a higher-than-expected inflation figure in Europe did not manage to compensate the modest positive surprises in the US Chicago purchase order index or the University of Michigan confidence index. Despite local markets responding positively to lower aversion during the week, at week-end nerves bounced back and sell biases dominated both for the MXN and in the curve.

Chart 1
Inflation forecast deviations Estimate less monthly observed on 1.5 standard deviations



Source: BBVA Research with Banamex survey data

Chart 2
Net foreign capital inflows to MBONDS (MXN, accumulated September 26-29)



Source: BBVA Research

Economic Analysis

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Calendar: Indicators

September Inflation (October 7)

Forecast 0.20% m/m 3.1% y/y	Consensus: 0.28% m/m	Prev: 0.16% m/m 3.4% y/y

Inflation throughout September maintained the favorable performance seen in the first fortnight supported by lower-than-expected increases in education prices and the fall in tourism, fruit and vegetable prices. Core inflation will decline from 3.2% to 3.1% in annual terms thanks to the favorable performance seen in services over the year as well as lower pressures on processed food prices. In turn, non-food goods need not be affected by the exchange rate performance given the current slack on the markets of factors, thus limiting the depreciation transfer onto consumers. We estimate inflation to close the year in December at 3.3% y/y with a downward rather than upward bias in the uncertainty range in line with that currently seen in agricultural product prices and output forecasts.

Consumer and Producer Confidence (October 3 and 4)

Forecast: Prod.-1.0 m/m (53.3 pts)	Consensus: N.A.	Previous: Prod. -3.4 m/m (53.8 pts.)
Forecast: Cons. 1.2 m/m (93.7 pts)	Consensus: N.A.	Previous: Cons. -1.3 m/m (92.5 pts.)

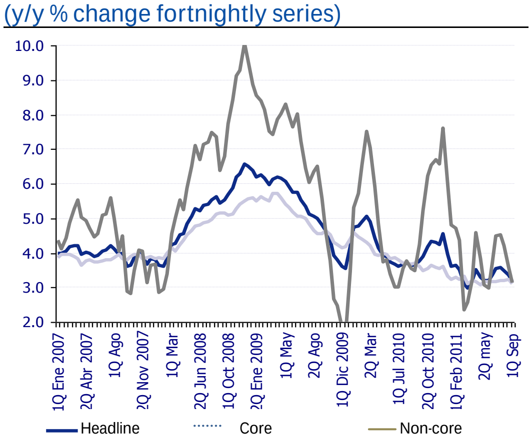
The trend in confidence indicators has deteriorated over recent months, specifically for the producer confidence indicator and sub-indices such as the future economic situation for the company and businesses. In this sense, the September indicator will be particularly important given the uncertainty surrounding global economic performance, which has already led to lower manufacturing exports in August and a weakening in variables such as the "right moment to invest".
Consumer confidence still shows a relatively more positive performance linked to the formal employment dynamic. In all, some moderation symptoms can be seen in household perspectives with the "ability to purchase a durable good" indicator which fell (-)5.8% in August, the second highest fall since March 2010.

Formal Employment in the private sector (over the week)

Forecast 0.28% m/m 4.0% y/y	Consensus: N.A.	Prev: 0.30% m/m 4.1% y/y

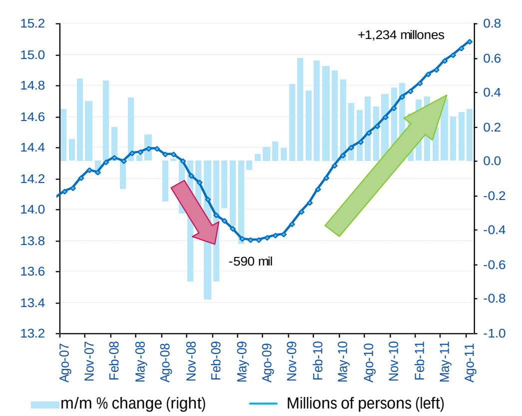
It is possible that some symptoms of lower growth start to be seen in formal private employment, especially in manufacturing, due to the recent slowdown in exports. The monitoring of wages in real terms will also be important, comprising the other component to salary mass in the formal sector - key in private consumption performance.

Chart 3
Inflation and components
(y/y % change fortnightly series)



Source: BBVA Research with INEGI data

Chart 3
Formal Private-sector Employment
(Level and % change m/m)



Source: BBVA Research with INEGI data

Markets

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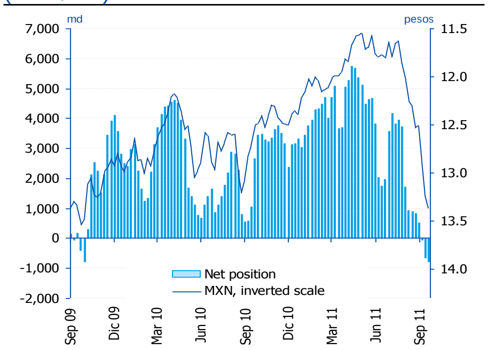
Overseas appetite for Bonds continues to decline at the end of the month.

Our forward indicators for overseas capital flows to the MBOND curve suggest that the decline in appetite has increased this week. From September 19 to 23, we estimate that foreigners decreased their positions around MXN 2.4 billion pesos, the most penalized notches being Dec. 2014, 2017 and 2024. From September 26 to 29, net sales from foreigners intensified, recording negative flows of MXN 16.722 billion pesos. The sale of medium- and long-term positions stands out. These estimates means the overseas capital flows for the month will be near zero or slightly negative. The high volatility in other assets over the last two weeks (mainly FX and Stock Markets) could be pressuring the sale of Bonds in emerging nations to limit risks and cover margin calls. Capital flow figures to emerging markets from the EPRF suggest an exit is already being consolidated, mainly in Equities.

Pressure on the MXN at the end of the week

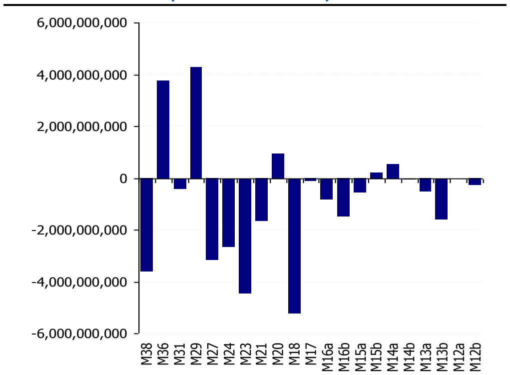
The MXN fell nearly 1.3% due to global risk factors and the close of local investor positions at the end of the month and quarter. In this way, the currency accumulated a 2.4% depreciation over the week. Banxico held its monthly put option auction on Friday for USD600mn, the results of which showed modest expectations of a short-term appreciation. The average premium was the highest since the auctions started in February 2010: MXN65.32 (MXN81.26 max.; MXN56.50 min.). Demand was 2.57 times supply and the condition to exercise options is the MXN breaking its 20-day rolling average (13.08). Although the MXN has fluctuated between 13.30 and 13.90, it will see high volatility as long as the fiscal situation in the EMU (liquidity problems) remains unresolved. In turn, according to the weekly CFTC report released on Friday with figures to September 27, the previous week recorded an increase in the MXN short non-commercial net position of USD 133mn, reaching a level of USD 772mn (near the net-short of USD 1.1bn in 2008).

Chart 5
Long non-commercial positions in Chicago (USD$mn)



Source: BBVA Research

Chart 6
Net foreign capital inflows to MBONDS (MXN, accumulated September 26-29)



Source: BBVA Research with Bank of Mexico data

Market Analysis
Equities

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Technical Analysis

IPC Stock Market Index

Source: BBVA, Bancomer, Bloomberg

The failure to break means the risk of a new movement toward minimum levels which we saw last week remains alive (around 32,000pts on the IPC). We believe that in order to have a market entry scenario, the IPC needs to be able to exceed the 34,200pts close level and, preferably, with major volume. If this break is seen, we believe that the upswing would be limited to the 35,200pts level, a major resistance in the last two months. At this point we would recommend cashing-in since we do not see the market still having the conditions to break upwards through this zone. The alternate scenario to take positions would come with a return to the zone between 31,700 and 32,000pts.

Previous rec.: We believe it is better to wait for the IPC to hit these minimums and see a favorable reaction in volume before taking speculative market positions.

MXN

Source: BBVA, Bancomer, Bloomberg

The dollar bounces from the 10-day rolling average opening the door to a new return to the MXN14.00 level. The over-buying conditions have not disappeared and we believe a break through this level would be complicated. We see major resistance and a possible double ceiling in this zone.

Previous rec.: With high over-buying and trading above any technical band, we believe that the adjustment started on Friday should remain towards levels at MXN13.50.

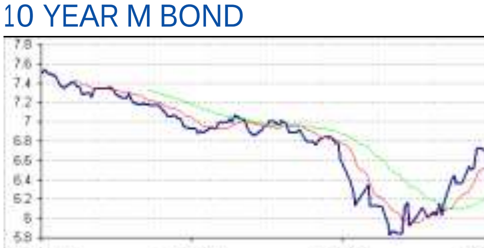
3Y M BOND

Source: BBVA, Bancomer, Bloomberg

3Y M BOND (yield): Returns to try initial support at the 10-day rolling average. We believe it should move up again and seek 5% and 5.2%. A bounce is ruled out with a close below 4.69%.

Previous rec.: We could expect a return to the 4.75% zone to then retake the upswing.

10 YEAR M BOND



Source: BBVA Bancomer, Bloomberg

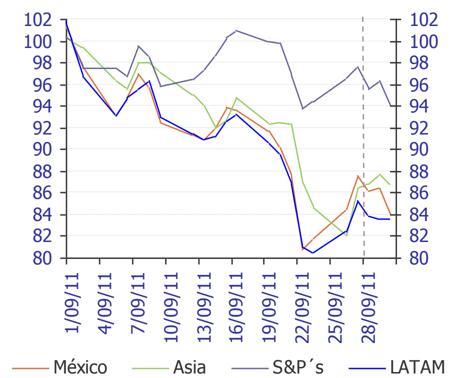
10 YEAR M BOND (yield): Return to the 6.5% support. It may be difficult to break 6.8% due to the gap between the 10- and 30-day rolling averages. As long as it does not break downwards through 6.5%, wait a movement toward next resistance.

Previous Rec.: It could return to 6.5% but may retake the upswing and seek out 7%.

Markets

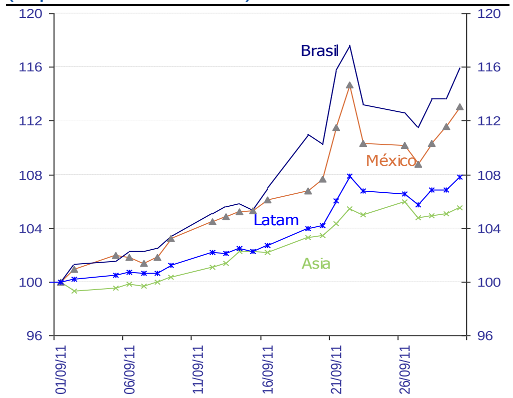
Global aversion to risk assets led to falls in emerging currencies and stock markets

Chart 7
Stock Markets: MSCI Indices (Index Sep 1, 2011= 100)



Source: Bloomberg & BBVA Research

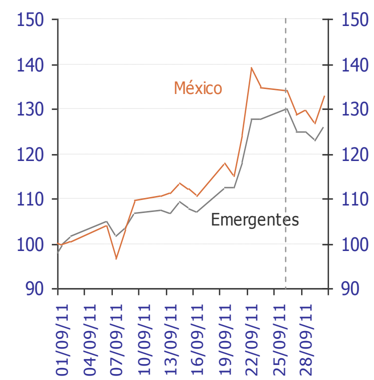
Chart 8
Foreign exchange: dollar exchange rates (Sep 1, 2011 index = 100)



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

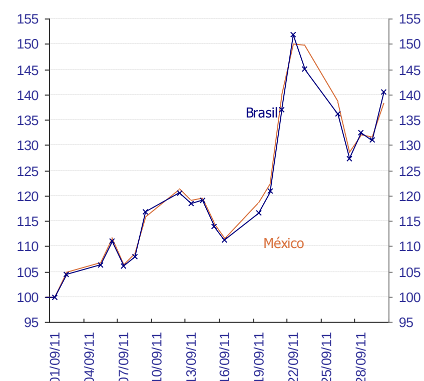
The increased aversion raised risk premiums for bonds from emerging countries.

Chart 9
Risk: EMBI+ (Sep 1, 2011 index = 100)



Source: Bloomberg & BBVA Research

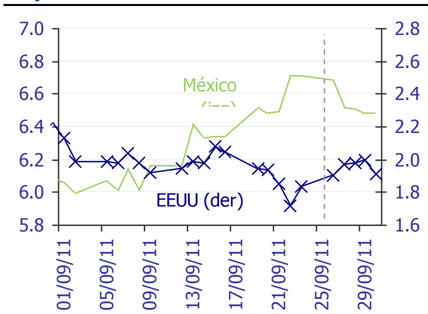
Chart 10
Risk: 5 year CDS (Sep 1, 2011 index=100)



Source: Bloomberg & BBVA Research

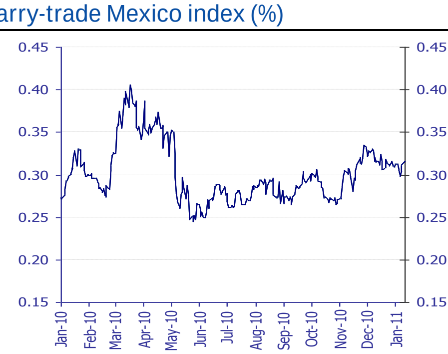
T-Bills saw rate falls as they are considered a safe-haven asset. Despite the increase in aversion, the 10-year Mexican Bond continued to pay at historically low rates

Chart 11
10-year interest rates*, last month



Source: Bloomberg & BBVA Research

Chart 12
Carry-trade Mexico index (%)

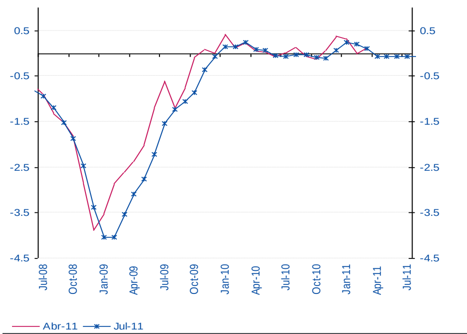


Source: BBVA Research with data from Bloomberg

Activity, inflation, monetary conditions

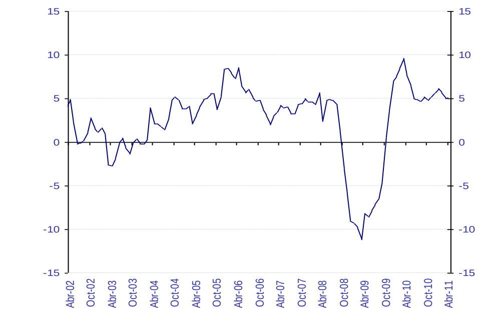
Increasing output in the third quarter of the year at levels near those in the previous period

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.

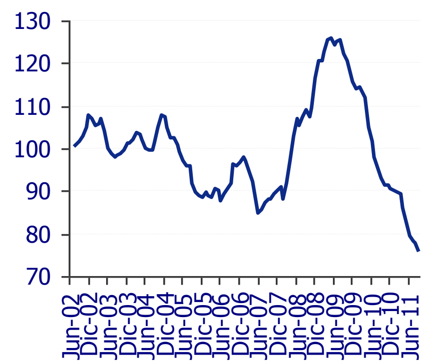
Chart 14
Advance Indicator of Activity (% change y/y)



Source: INEGI

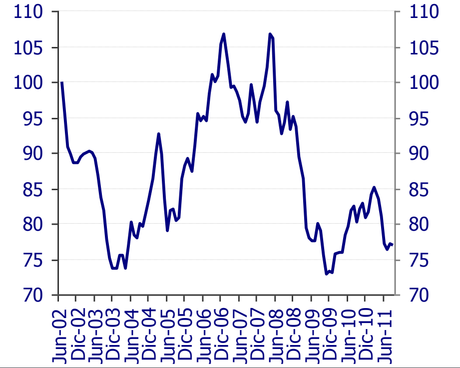
Recent inflationary surprises have been downward, while those concerning economic activity have been mixed.

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.

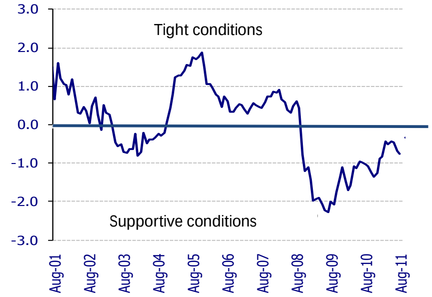
Chart 16
Activity Surprise Index (2002=100)



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.

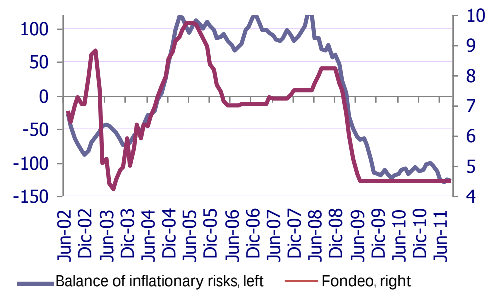
Monetary conditions relaxed slightly due to recent exchange rate depreciation

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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