BBVA Group Economic Research Department

Weekly Watch

Mexico

October 7, 2011

Next week…

Economic Analysis

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... Banxico decides again. It will hold at 4.5%. And in December? It will also hold if the global scenario gets no worse and the exchange rate is favorable

If we take heed of market and analyst expectations, it seems unlikely that Banxico will change the lending rate at its next meeting on October 14. The fall in the exchange rate over the last three weeks has, for markets, eliminated the discount they were previously forecasting for a 25 bp cut as soon as this meeting. For the latter, there are several brakes on the "downward enthusiasm". Firstly, the exchange volatility and possible effect on inflation, highly limited in our view given the lack of demand pressures. Secondly, there are domestic growth forecasts which, on average, come in at 3.8% for 2011 and 3.5% for 2012 for analysts, the same figures released by Banxico as a low range for expectations. In our opinion, these forecasts do not require a lower lending rate, especially if we continue to believe that Banxico is not exactly very pro-active when making decisions. Nonetheless, this may be changing with the current Board debate at the bank as seen in the minutes. This change is surely not separate from the speed at which the economic scenario may worsen. In any case, we believe that the lending rate will remain unchanged, although we will need to closely monitor economic performance, monetary conditions (highly dependent on the exchange rate performance) and Banxico press releases over the next eight weeks before the December 2 decision.

Market Analysis

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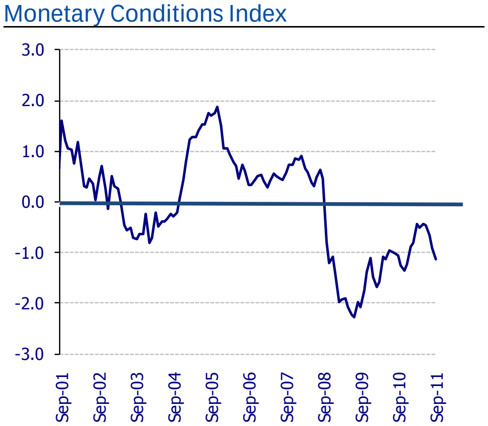
Financial tensions reduce over Europe, although they remain high: wide trading ranges for the MXN and gains on local curves

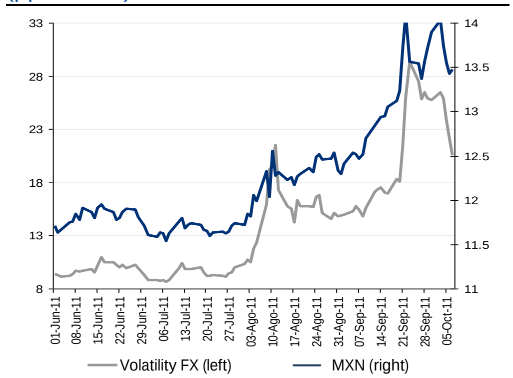
Although tensions in the financial markets have receded, they remain high, and the MXN will continue to trade within broad ranges with gains on local curves supported by low stable inflation. The Mexican stock exchange will seek supports in US corporate earnings.

Chart 1
Monetary Conditions Index



Source: BBVA Research

Chart 2
Mexico: USDMXN and implied volatility 1 month (ppd and %)



Source: BBVA Research

Calendar: Indicators

Economic Analysis

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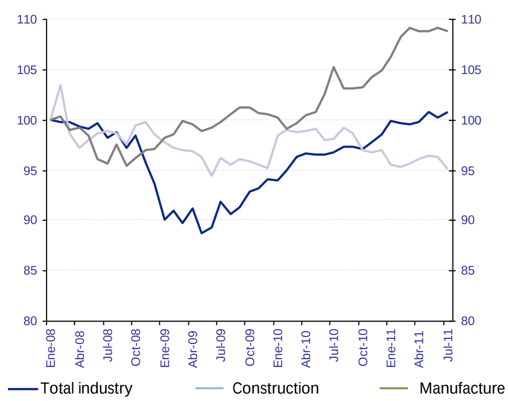
Industrial Output in August (October 12)

Forecast 0.1% m/m 3.7% y/y Consensus: N.A. Prev: 0.5% m/m 4.1% y/y

Some situation indictors such as US manufacturing output and domestic automotive production point to a certain slowdown in domestic industrial output in August. According to AMIA figures, automotive production went from 10.8% average growth in May to July to -11.8% in August; most of the slowdown was in automotive production for export (-14.3% m/m vs. 11.9% m/m in the previous three months). In turn, the other major component for output, construction, grew for four months in a row meaning the growth trend started in 2010 remains. Nonetheless, in level terms, construction industry output value remains below 2008 levels.

Chart 3
Industries: Construction and Manufacturing (Jan 2008 = 100)



Source: BBVA Research with INEGI data

Markets

Market Analysis

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Reduced financial tensions, although sovereign debt sensitivity continues...

Tensions on financial markets reduced over the week although remain high and sensitive to new events. At the start of the week, adverse news on the euro region stood out: capital requirements of a Franco-Belgian bank (Dexia), Moody's downgrade of Italy and weakness in the manufacturing sector in the region. The cut in Spain's credit rating by Fitch at the start of the week also stood out. Despite this, financial tensions moderated thanks to (1) statements in Europe on coordinated help for European banks under uniform community criteria; (2) Bernanke's speech on the capacity in implementing additional monetary measures; (3) slightly better-than-expected job figures in the US; (4) an extension in the asset purchase scheme at the Bank of England and (5) the ECB's announcement of measures in support of financial system liquidity (see chart 12- and 13-month LTROs and Covered Bonds purchase up to EUR40bn).

...leading to wide MXN trading ranges...

After hitting highs for the year in the last week of September (30%), implied one-month foreign-exchange volatility has come in at high levels 20% (vs. minimums of 7.8% over the year). In this sense, the MXN maintained high intraday trading ranges over the week (from 13.2 to 14.09) suggesting that the trend of ranges versus innovations will continue with regards to sovereign conditions and global cycles. Although the MXN ended the week up by 3.5% (just below the BRL's performance), the upward range moving forward is limited and there is appetite for the USD to be below the 13.2 level. However, we cannot rule out levels up to 13.8 if bad economic news comes out.

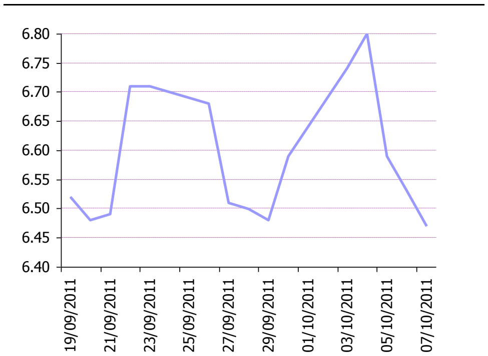
...and gains in local curves also supported by low inflation.

Local curves end the week with general gains. A lower global risk premium alongside the good inflation performance (justifying the prolonged monetary pause with a reduction bias from Banxico) were the main driving force for the curve. We continue to forecast a flattening-out, although it will not be smooth, the global risk continuing to set the curve pattern.

The IPC sees a worse relative performance to developed nations' markets.

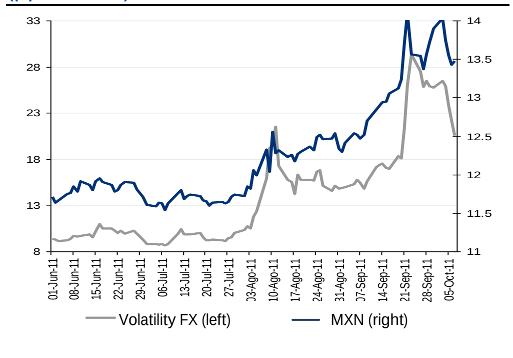
Global stock markets have been following the flow of information on sovereign risk. In this situation, markets in developed countries, which so far have been more affected by the distortion of the risk premium, performed slightly better than emerging markets and Mexico. Over the coming weeks the markets are unlikely to change the focus of attention from sovereign risk to corporate results; nevertheless, it will be key for these results, particularly in the U.S., to be at least as good to continue providing support to some hard-hit ratings.

Chart 4
Mexico: Long-term fixed rate M10 (%)



Source: BBVA Research

Chart 5
Mexico: USDMXN and implied volatility 1 month (ppd and %)



Source: BBVA Research with Bank of Mexico data

Market Analysis
Equities

Technical Analysis
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Technical Analysis

IPC Stock Market Index

Over the week the IPC tried the 33,000pts, although it could not realize a bounce from that floor. The opening that the 10-day and 30-day rolling averages have suggests a movement to the latter to levels near 34,000pts. Only an upward breakthrough of this level would lead us to set a following target up to 35,200pts. We believe that Amx has hit major floor levels and, contrary to what we saw over the last week, could help the market realize this short-term upswing. The initial floor we should consider for the IPC below 33,000pts comes in at 32,200pts and then up to 31,700pts.

Previous Rec.: We believe that in order to have a market entry scenario, the IPC needs to be able to exceed the 34,200pts close level.

Source: BBVA Bancomer, Bloomberg

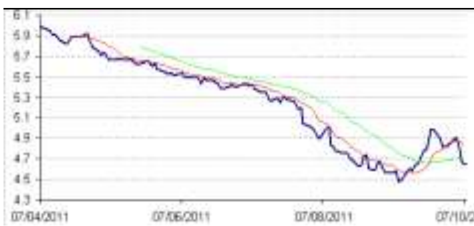
MXN

The dollar again traded above MXN14.00 over the week, hitting resistance and marking a "double ceiling" formation to start an adjustment move. It broke down through the initial support at the rolling 10-day average (MXN13.70) but could not close the week below MXN13.35, the previous minimum. We believe it should retake the adjustment and seek levels near MXN13.00 over the coming week.

Previous Rec.: We see major resistance and a possible double ceiling at MXN14.00.

Source: BBVA Bancomer, Bloomberg

3Y M BOND

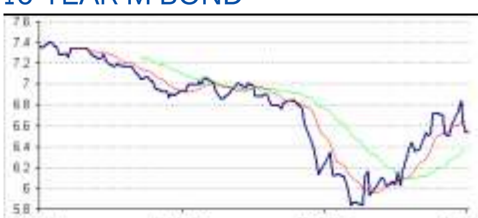


3-YEAR M BOND: (yield): Return below the 30-day rolling average, removing the upswing signals. Support level at 4.5%. It should retake an upward trend above 4.65%.

Previous Rec.: We believe it should move up again and seek 5% and 5.2%. A bounce is ruled out with a close below 4.69%.

Source: BBVA Bancomer, Bloomberg

10 YEAR M BOND



10Y M BOND (yield): Correction but in line with the 30-day rolling average. Maintaining its short-term upward trend with support at 6.39% and resistance at 6.8%.

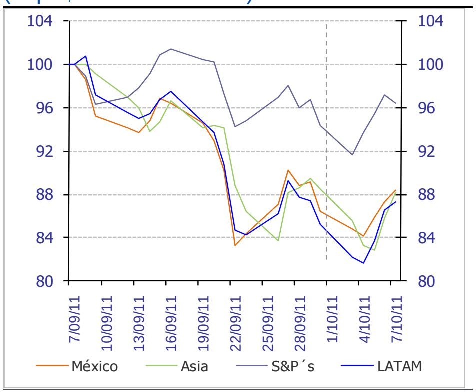
Previous Rec.: It could, as long as it does not break downwards through 6.5%, wait a movement toward next resistance.

Source: BBVA Bancomer, Bloomberg

Markets

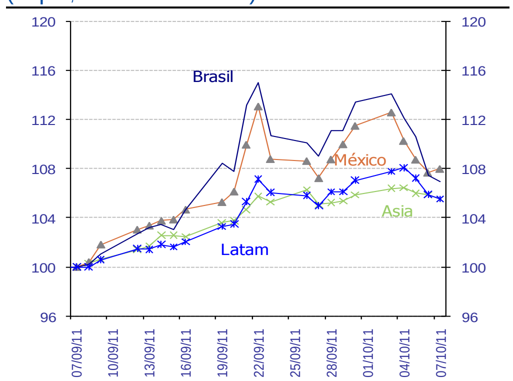
Cut in Italian and Spanish sovereign debt rating by Fitch rules out gains on share markets after the better-than-expected job figures in the US. The peso appreciated over the week despite high volatility on the last day.

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



Source: Bloomberg & BBVA Research

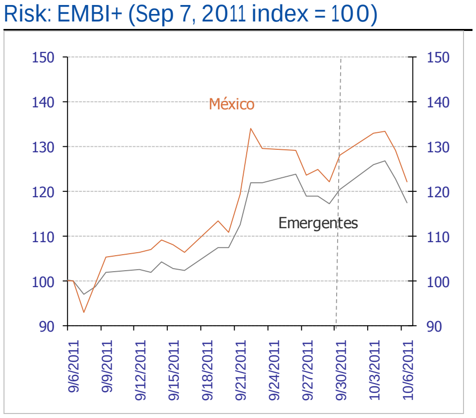
Chart 8
Foreign exchange: dollar exchange rates (Sep 7, 2011 index = 100)



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

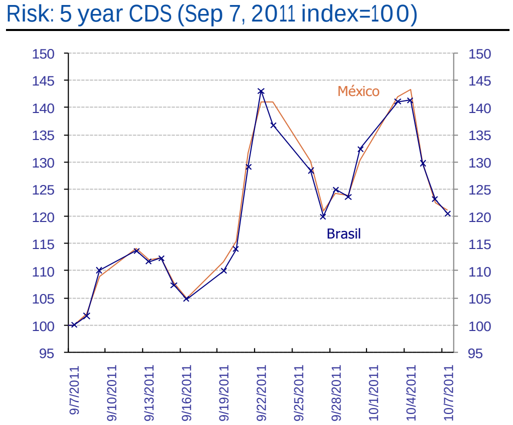
Statements in Europe on coordinated support for the banking system, additional ECB measures and better-than-expected job figures in the US lower risk aversion over the week

Chart 9
Risk: EMBI+ (Sep 7, 2011 index = 100)



Source: Bloomberg & BBVA Research

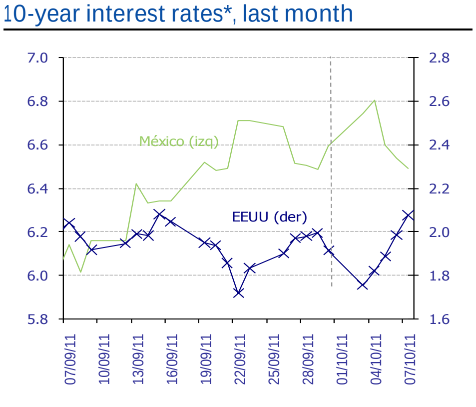
Chart 10
Risk: 5 year CDS (Sep 7, 2011 index=100)



Source: Bloomberg & BBVA Research

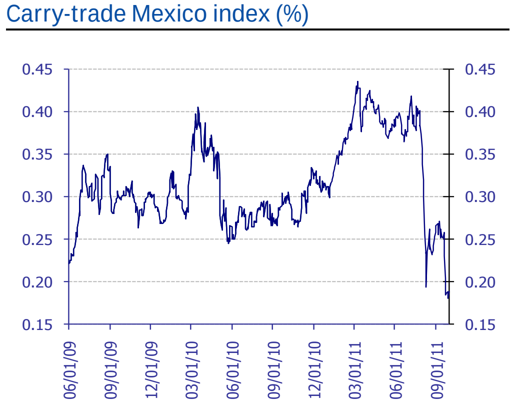
Inflation decline in Mexico leads to reduced long-term rates. Reduced risk aversion over the week increases T-Bill yields

Chart 11
10-year interest rates*, last month



Source: Bloomberg & BBVA Research

Chart 12
Carry-trade Mexico index (%)

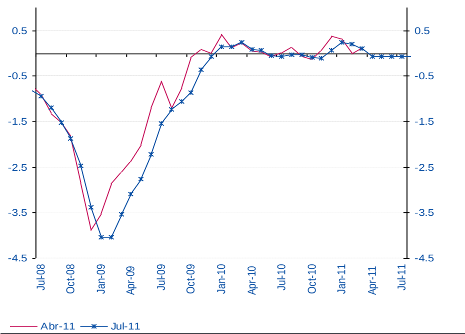


Source: BBVA Research with data from Bloomberg

Activity, inflation, monetary conditions

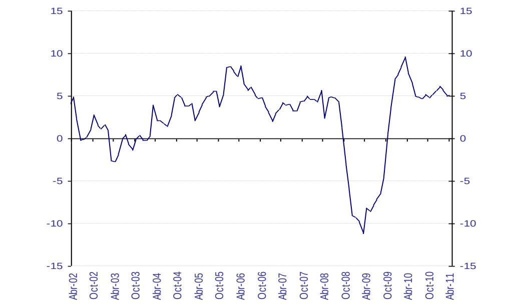
Output holds positive performance, situation indicators point to 3Q11 above 2Q in quarterly rate

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.

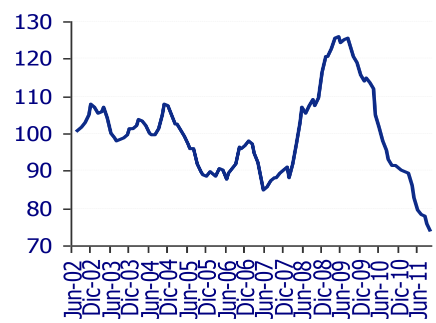
Chart 14
Advance Indicator of Activity (y/y % change)



Source: INEGI

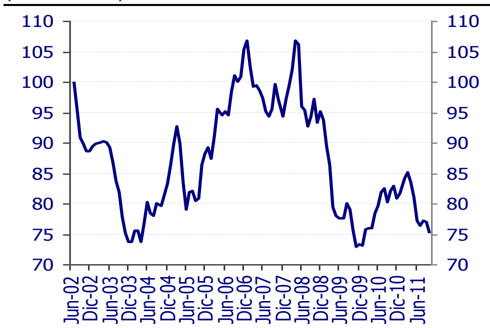
Recent inflationary surprises have been downward, while those concerning economic activity have been mixed.

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.

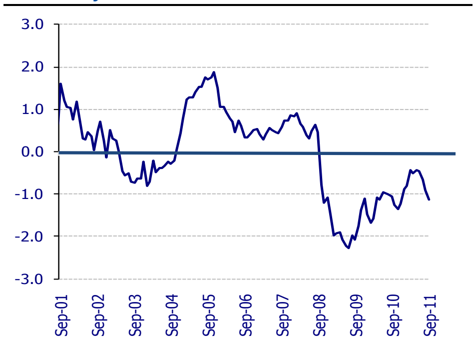
Chart 16
Activity Surprise Index (2002=100)



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.

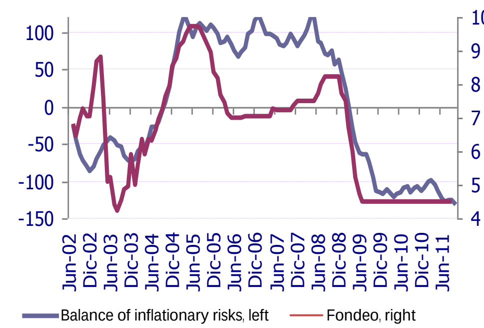
Monetary Conditions relax due to recent exchange rate depreciation

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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