BBVA Group Economic Research
Department

Weekly Watch

Mexico

October 14, 2011

Economic Analysis

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Market Analysis

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Next week...

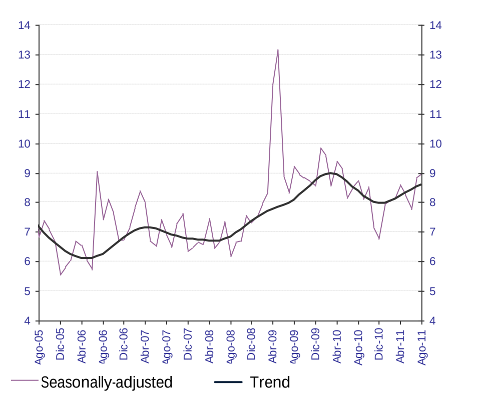
... with our eyes outside Mexico

If the last few weeks have shown us something, it is the lack of relevance of domestic economic indicators in defining local financial variables. *And* this is good. This situation has shown that potential domestic uncertainties are not where investor concerns lie that have increased long rates and depreciated the peso, taking their decisions without distinguishing Mexico from other emerging economies, independently of their inherent characteristics regarding financial strengths or the level of exposure to factors such as the US cycle and commodity prices. In this sense, the parliamentary proceedings for the 2012 budget, which should be passed at in the next week in the House of Representatives, should be an uncertainty factor for the Mexican economy, important for when the tide of global risk premium decreases and differences are made between economies. In any case, next week's unemployment and retail sales figures will allow us to gage the tone and household expenditure forecasts, one of the main elements of Mexican growth in recent months.

A week of respite for global markets, domestic monetary signs lead to different biases

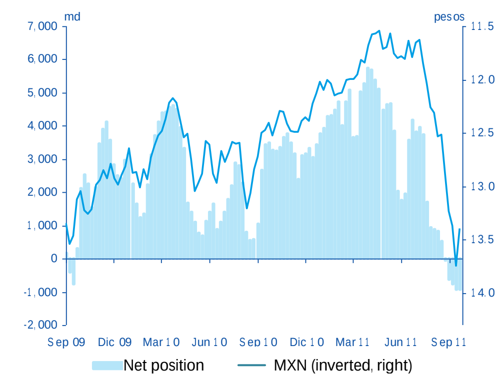
Although attention over the week focused on favorable forecasts for sovereign risk performance in the Eurozone and in the Fed's minutes, the Bank of Mexico managed to hog the spotlight with a surprise gentler-than-expected economic policy release and warning of a coming fall in the policy rate. Subsequently, domestic financial markets will allocate biases in their short-term dynamics. On the one hand, we cannot rule out the MXN starting to incorporate more aggressive cut forecasts to those already priced in. This should limit the appreciation margin. In fixed income, the announcement will limit any attempt of a curve bounce and maintains flattening space open until monetary authorities start their cuts cycle.

Chart 1
Under-employment
(% of employed population)



Source: BBVA Research

Chart 2
Long Non-Trading Positions in CME (US$mn and ppd)



Source: BBVA Research

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Calendar: Indicators

Economic Analysis

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Retail Sales in August (October 20)

Forecast: -0.3% m/m (2.8% y/y)	Consensus: N.A.	Prev: 0.4% m/m (4.3% y/y)

The decline in manufacturing output released this week could also be linked to lower retail sales in August. It should be taken into account that although formal private sector employment performance remains strong and increasing at rates around 0.4% m/m, the consumer confidence index has started to show signs of weakness, especially in indicators such as the likelihood of purchasing a durable good in the near future. The forecast decline in retail sales is, however, in line with year-on-year growth of around 2.8%. In turn, it will be important to see how the income index performed in the services sector in August. It should be taken into account that this variable has performed satisfactorily in recent months with an average growth of 0.8 in the last three months, 0.5 in the previous three months, although there is a wide difference between the services branches looked at. Services such as scientific and technical professionals and transport and storage services are particularly positive highlights.

Unemployment rate in September (October 21)

Forecast 5.5% SA	Consensus: N.A.	Previous: 5.4% SA

The unemployment rate continues to resist decreases in line with the EAP. It should be stated that the rate has remained around 5% from the start of the economic crisis in 2009. It will be important to assess the proportion of under-employed within the employed population alongside the unemployment rate. This rate is around 9% which, in turn, is linked to the low salary level in real terms of many of those with jobs.

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Markets

A week of respite for global markets, domestic monetary signs lead to different biases

Respite for markets continued last week with a reduction in sovereign tension in Europe (despite Spain's downgrade) and with Fed minutes underlining its commitment to act if things gets worse. The Troika in the Eurozone (the ECB, EC and IMF) highlighted the advanced in Greek consolidation and opened the door to the new support tranche for the country; Slovakia passed the EFSF enlargement (the last country to do so) which will lead to an extended protection cover for the facility. The European Commission (Barroso) set out the action plan for resolving sovereign debt.

On the domestic front, the Bank of Mexico's release stole the spotlight by highlighting that surprise downward inflation had continued while growth forecasts have got worse due to global issues. In the face of this and the global monetary weariness, Banxico warned about a possible fall in its policy rate which sets different domestic market forecasts:

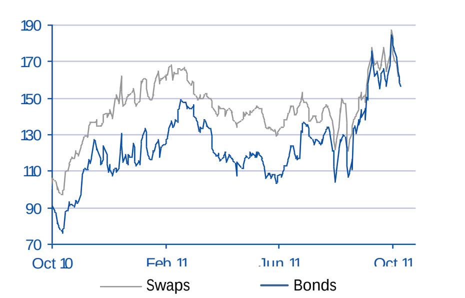
Surprise downward sign in policy rate, limiting appreciation margin...

The Banxico monetary policy decision took place on Friday and the release was *milder* than expected. The market is therefore factoring in a minimum 25bp cut in December (we forecast a 25bp cut in December and a similar move in January). The news had no effect on the MXN which, in our opinion, is due to the release highlighting the undervalued currency and a forecast for rises in line with the fundamentals of the Mexican economy (as per statements from A. Carstens in recent days). In the short term, we cannot rule out the MXN starting to incorporate more aggressive cut forecasts to those already priced in. This should limit the appreciation margin.

...and any attempted upswing in the curve

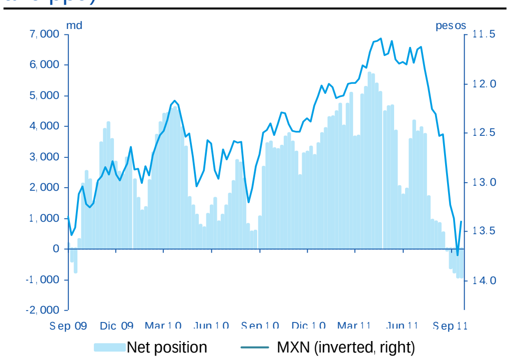
In turn, debt markets ended the week as they began, with a significant *rally* driven both by greater stability on international markets and the effect of Bank of Mexico's release. The statement strengthens the implicit expectation in the curve that the Bank of Mexico could lower the lending rate at the end of the year and/or the start of 2012. This will limit any attempted upswing in the curve and leave flattening space open until monetary authorities start their cuts cycle.

Chart 4
Mexico: Long-term curve slope (10A/3Y)



Source: BBVA Research

Chart 5
Long Non-Trading Positions in CME (US$mn and ppd)



Source: BBVA Research with Bank of Mexico data

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Technical Analysis

IPC Stock Market Index

The IPC came in above the 30-day rolling average (33,914pts) and hit 35,000pts. As with S&P we can see a pull-back to levels around 34,000pts to retake an upward movement seeking out 35,800pts. This pull-back would provide a new entry opportunity. We believe that an adjustment in Amx may cause this pull-back although a return to the MXN15.00 zone should be seen as the purchase zone. The alternative entry scenario would be the Amx breaking upwards to MXN16.00

Previous Rec.: The opening that the 10-day and 30-day rolling averages have suggests a movement to the latter to levels near 34,000pts.

Source: BBVA Bancomer, Bloomberg

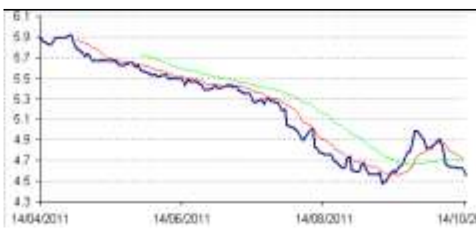
MXN

After the adjustment from the double MXN14.10 ceiling, the dollar has started to bottom at the 30-day rolling average. The oscillating indicators suggest that it still change may seek out levels around MXN13.15 or even MXN13.00. Only an upward breakthrough through MXN13.50 (10-day rolling average) would rule out this higher peso appreciation forecast.

Previous Rec.: We believe it should retake the adjustment and seek levels near MXN13.00 over the coming week.

Source: BBVA Bancomer, Bloomberg

3Y M BOND



3 Y M BOND: (yield): Maintaining its downward move and hitting levels already near the 4.5% minimum. Major support from where it could again bounce; however, we would consider a stop loss if it breaks downward.

Previous Rec.: Return below the 30-day rolling average, removing the upswing signals.

Source: BBVA Bancomer, Bloomberg

10 YEAR M BOND

10-YEAR M BOND: (yield): Downward break through the 30-day rolling average, removing the upswing signals. Support up to 5.9% and resistance at 6.4%.

Previous Rec.: Could maintain its short-term upward trend with support at 6.39% and resistance at 6.8%.

Source: BBVA Bancomer, Bloomberg

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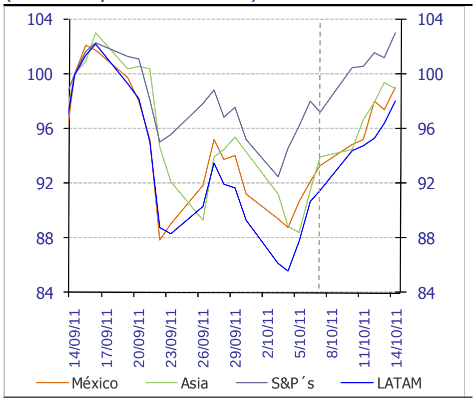
Markets

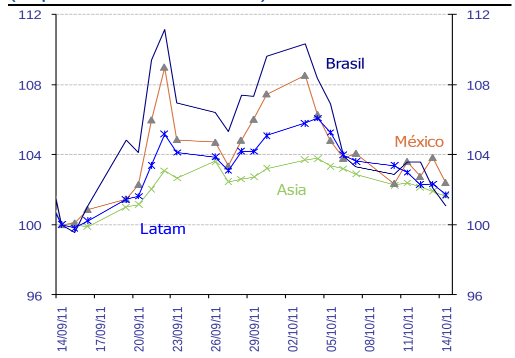
US retail sales figures above forecasts and optimism on possible agreements in the European debt crisis at the G20 meeting lead to stock markets closing the week with gains. The peso strengthens due to the factors above.

Chart 7
Stock Markets: MSCI Indices
(Index Sep 14, 2011= 100)



Source: Bloomberg & BBVA Research

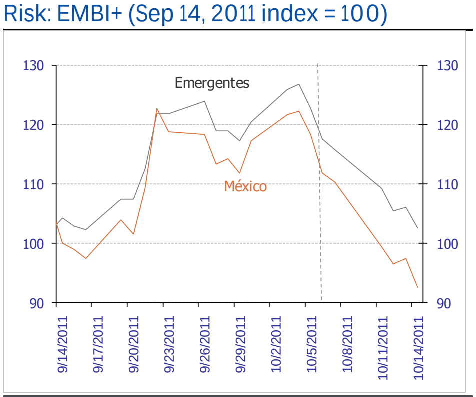
Chart 8
Foreign exchange: dollar exchange rates
(Sep 14, 2011 index = 100)



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

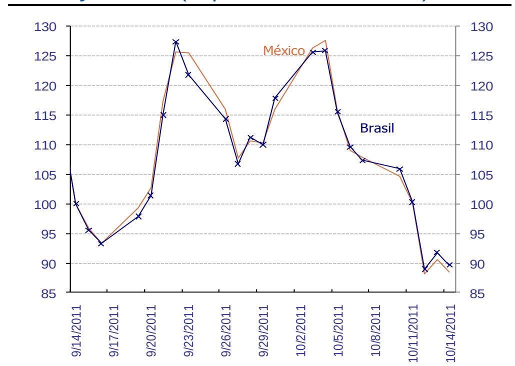
Better-than-expected U.S. figures in the week /e.g. unemployment applications, retail sales) support a reduction in risk aversions

Chart 9
Risk: EMBI+ (Sep 14, 2011 index = 100)



Source: Bloomberg & BBVA Research

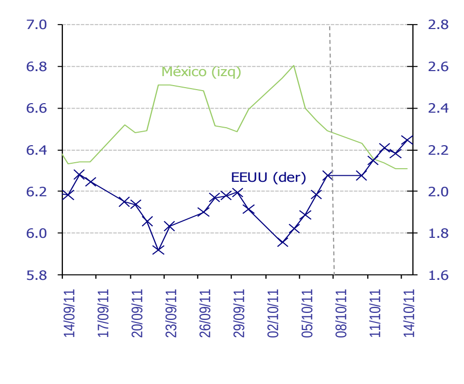
Chart 10
Risk: 5 year CDS (Sep 14, 2011 index=100)



Source: Bloomberg & BBVA Research

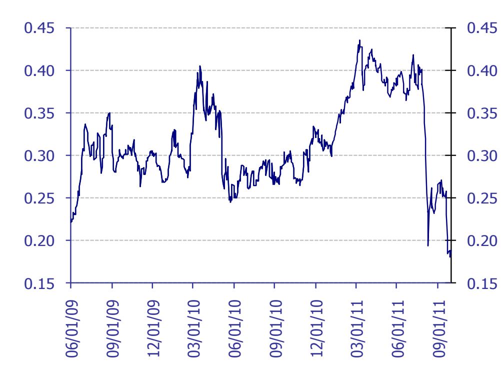
Rates in Mexico down due to the monetary policy release which points to a fall in the lending rate in December. US rates increase in the face of higher risk appetite

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

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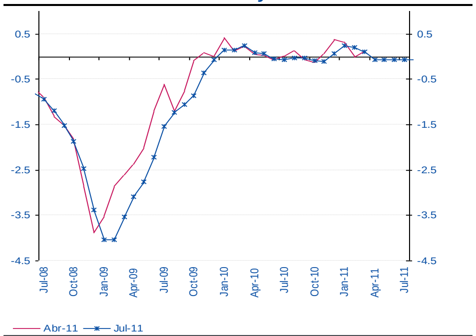
Activity, inflation, monetary conditions

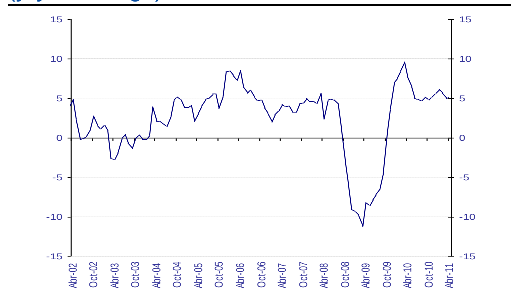
Output holds positive performance, situation indicators point to 3Q11 above 2Q in quarterly rate

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.

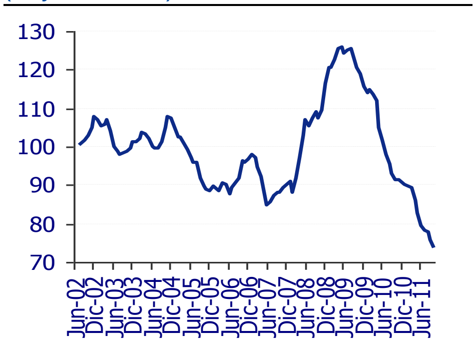
Chart 14
Advance Indicator of Activity (y/y % change)



Source: INEGI

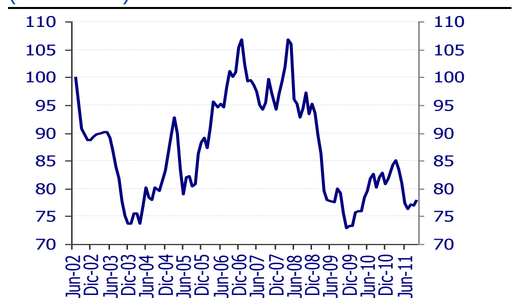
Recent inflationary surprises have been downward, while those concerning economic activity have been mixed.

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.

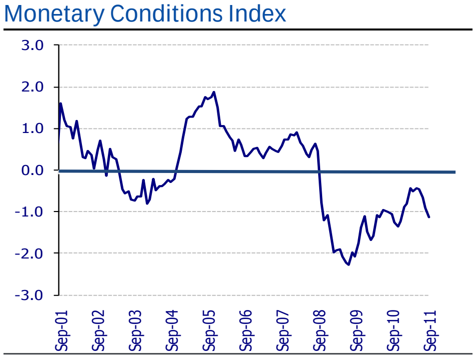
Chart 16
Activity Surprise Index (2002=100)



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.

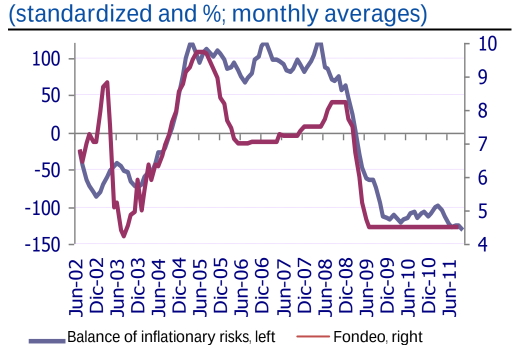
Monetary Conditions relax due to recent exchange rate depreciation

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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