BBVA | RESEARCH

BBVA Group Economic Research Department

Weekly Watch

Mexico

October 21, 2011

Economic Analysis

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Market Analysis

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Next week...

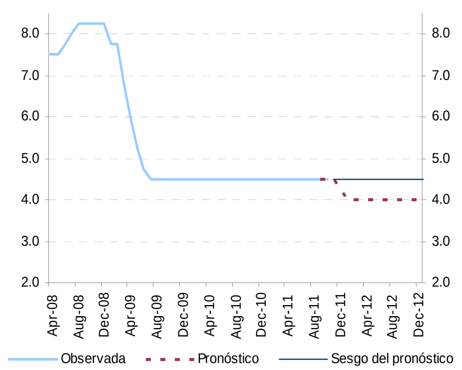
... focus on Banxico minutes

Next week sees the release of inflation figures for the first two weeks of October. We believe they will come in at 3.1% despite the fall in the exchange rate. This means it will be clear inflation is not a pressure point for Banxico monetary policy decision. In this sense, the Board's viewpoints will be important with regard to the appropriateness of a cut in the lending rate where the minutes from the last meeting pointed out that there are some members who see this measure as costly in terms of sending the wrong signal to markets if the balance of risks over prices suddenly deteriorated. The exchange of opinions on the costs and benefits to a change in monetary policy stance is even more importance given the recent global risk episodes which led to a fall in the peso and a major increase in exchange rate volatility.

Markets in Mexico will be sensitive to the assessment of measures in Europe

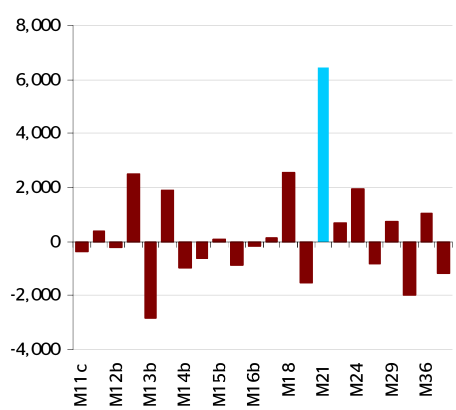
MXN sees high volatility while no credible measure for investors are seen; a return to 13.0 in the MXN cannot be ruled out in coming weeks if current tensions weaken. In fixed-income, the net overseas purchases stood out for continued irregularity as seen throughout the year. The week ended up in the MBOND long curve with a flattening bias.

Chart 1
Lending rate outlook



Source: BBVA Research

Chart 2
Net Foreign Inflows to MBOND curve (millions of MXN) October 3-20



Source: BBVA Research with Banxico and Indeval

Calendar: Indicators

Economic Analysis

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Inflation for the first two weeks in October (October 24)

Forecast 0.47 bi-weekly (3.1% y/y)	Consensus: 0.44% bi-weekly	Prev: 0.25% m/m (3.16% y/y)

Inflation for the first half of October will be released next Monday. We expect the rate in the first fortnight to come in at 0.47% bi-weekly driven by upward moves in electricity tariffs due to the start of the winter season as well as upward pressures in fruit and vegetable prices and livestock products, all being none-core prices. In contrast to these volatile factors, we expect core inflation to increase by a mere 0.13% bi-weekly, remaining in check despite the fall in the exchange rate, due to domestic demand continuing weak and thus limiting cost increases being passed on to consumer prices. We expect inflation to end the year around 3.3% y/y. Nonetheless, we see a downward bias for our forecast if economic output shows sign of weakness.

September Trade Balance (October 25)

Forecast -430 md dollars	Consensus: N.A.	Previous:-806 md

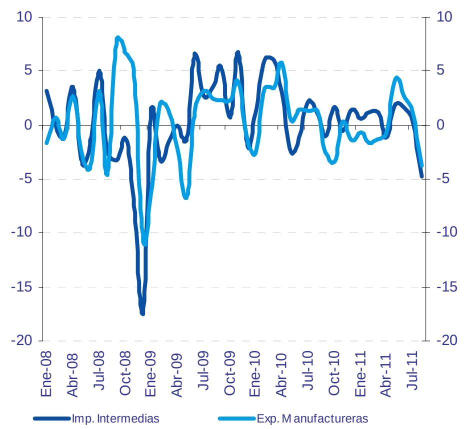
The Trade Balance for September will be released on Wednesday. These figures are important in terms of confirming or ruling out a slowdown in trade of goods overseas after intermediate imports and manufacturing exports (the most important items for international trade) saw a fall in monthly growth in August; this could, in principle, be temporary and due to automotive production line adjustments. In all, we expect the trade gap for September to be around 430 md - a contained consistent deficit with a stronger recovery in foreign rather than domestic demand.

IGAE in August (October 27)

Forecast -0.3% m/m (3.7% y/y)	Consensus: N.A.	Prev: 0.9% m/m (4.5% y/y)

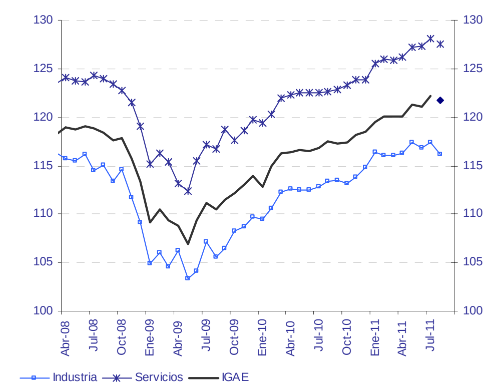
The decline in industrial output in August (-1.1% m/m, 0.62% average growth in the previous three months) could lead to lower growth and even a fall in services. It should be stated that the performance in retail sales and aggregate revenue in services point to, in this sense, retail sales contracting (-)0.3% m/m in August (-0.1% three previous months) while services grew 0.2% (0.8% m/m three previous months). The fall in industry in August (the highest since August 2009) was linked to lower foreign demand, especially in the automotive sector.

Chart 3
Manufacturing exports and intermediate imports (real y/y % change)



Source: BBVA Research with Banxico and INEGI data

Chart 2
IGAE, SA (2003 Indices=100)



Source: BBVA Research with Banxico and Indeval

Markets

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Markets sensitive to news on sovereign risk and awaiting measures

Investors await measures to resolve sovereign problems in the Eurozone and restore market confidence. Some positive indicators in the US (manufacturing survey in Philadelphia and home construction) and forecasts in China (GDP 3Q) were not even important for moderating fluctuations. The sensitivity was made clear after statements from German authorities on not expecting immediate solutions and then correcting the negative sense by announcing a new meeting on October 26 where more convincing measures could be proposed.

MXN sees one of the highest weekly falls due to Eurozone risks ...

The MXN saw one of its highest weekly falls (-3.16%) (alongside the South African Rand) in emerging economies showing its sensitivity to sovereign tensions, without taking into account the good Philly Fed figures (weekly fluctuation between 13.81 and 13.14). If sovereign agreements are reached in the Eurozone possibly generating confidence in coming weeks, it could lead to a quick return to the 13.0 zone. Nonetheless, volatility will continue to be high and we will remain outside directional positions in coming days.

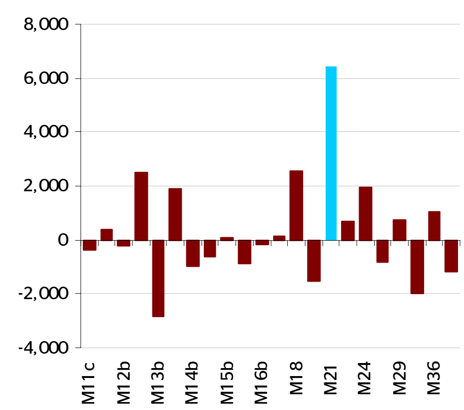
...and net foreign inflows continue to be uneven in the month

Only the appetite for medium tranches stands out, dominated by the M2021. In turn, Siefores have turned to these tranches but the return to longer curve references stands out. The week ended with gains in the MBOND long curve with a flattening bias, which was seen more over the TIIE curve (volatility was constant over the week).

Good corporate reporting in the US but concern over sovereign risk news

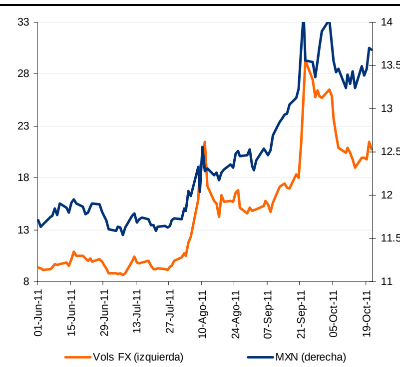
Global stock markets were also volatile over the week and extremely sensitive to comments by the European authorities with respect to measures that could be adopted between October 23-24 and 26 at the Eurogroup meeting. In this situation, markets in developed economies, particularly Europe, were most vulnerable to corrections, while emerging markets stand out, particularly Asia. The corporate reports have so far been positive in U.S., although it is still early to make a final judgment. So far, sales are up 6.5% in the U.S. and EPS 14.4%. As we expected, the reports had little effect on stock markets given the lack of solutions to the sovereign/financial risk situation in Europe. However, it is still important that they remain in positive territory to confirm the support levels that have been in place and tested for some months.

Chart 4
Net Foreign Inflows to MBOND curve (millions of MXN) October 3-20



Source: BBVA Research with Banxico and Indeval

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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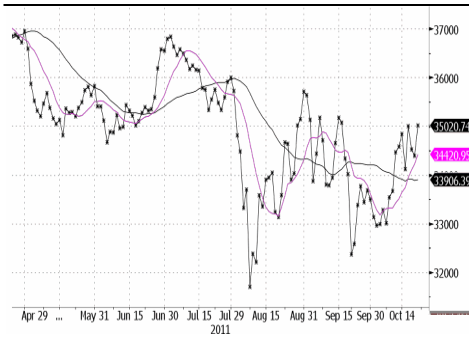
Technical Analysis

IPC Stock Market Index

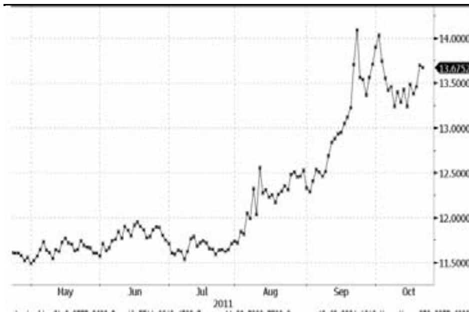


Source: BBVA Bancomer, Bloomberg

The IPC remained above the 10- and 30-day averages which saw a positive crossover. Therefore, despite the volatility seen over the last 10 days, we expect the IPC to remain in a zone where it is able to support major volatility.

Previous Rec. (October 17, 2011): 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.

MXN

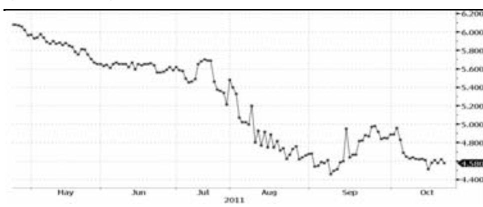


Source: BBVA Bancomer, Bloomberg

After several trading sessions between MXN13.20 and MXN13.50, the dollar broke upwards through this short-term resistance which again pressured the peso, again setting MXN14.00 as the resistance level. To again see a strengthening scenario for the peso, it has to hit levels below MXN13.43 where the 30-day rolling average is trading.

Previous Rec.: Only an upward breakthrough through MXN13.50 (10-day rolling average) would rule out this higher peso appreciation forecast.

3Y M BOND

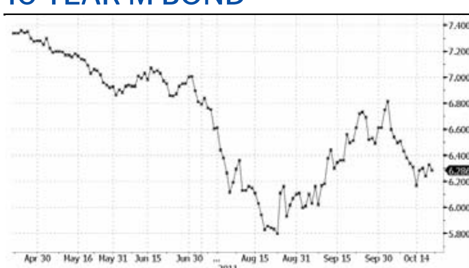


Source: BBVA Bancomer, Bloomberg

3-YEAR M BOND: (yield): Sideways movement characterizing recent weeks remained. The movement is slack in the channel it has set since September which appears to indicate that no new minimums will be hit in the short-term.

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

10 YEAR M BOND



Source: BBVA Bancomer, Bloomberg

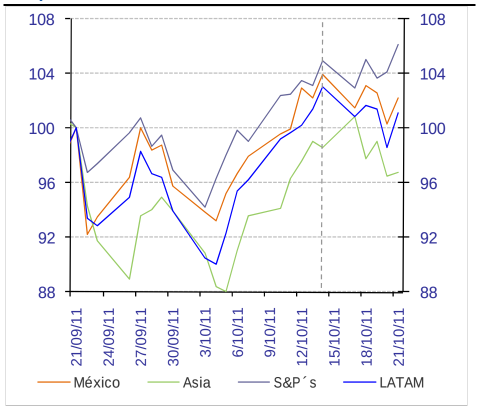
10Y M BOND (yield): The correction seen since the start of October (which started at 6.8% levels) reached the third Fibonacci level this week at the 6.20% mark. This means the downward movement could find a floor and end near current levels. However, an upward bounce signal has not taken form and we will need to wait for a combination of ups and downs for it to take shape.

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

Markets

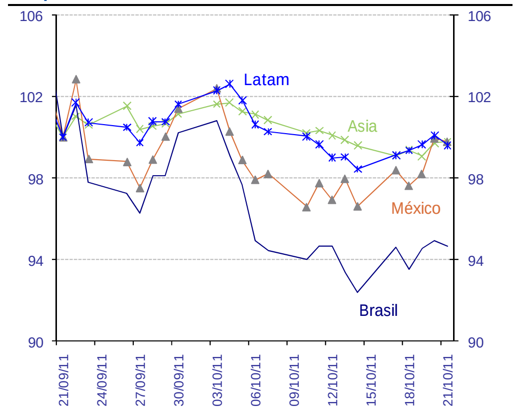
Optimism over an agreement being reached on the European debt problems, as well as FED member statements on a new round of fiscal stimulus, led to highs on stock markets and currency rises.

Chart 7
Stock Markets: MSCI Indices (Sep 21, 2011 index = 100)



Source: Bloomberg & BBVA Research

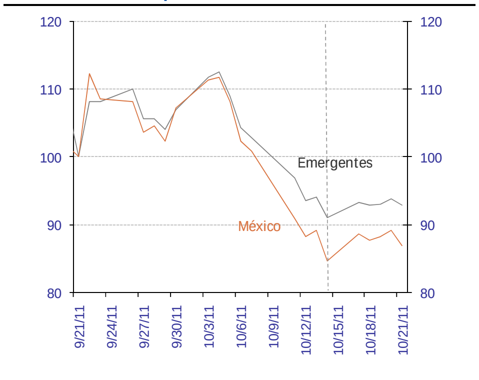
Chart 8
Foreign exchange: dollar exchange rates (Sep 21, 2011 index = 100)



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

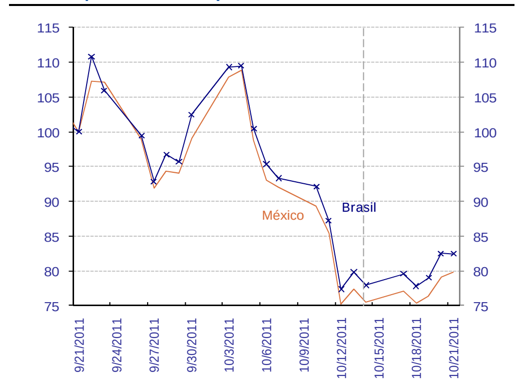
Risk aversion remains with no major changes in expectation of possible agreements at the European summit next week

Chart 9
Risk: EMBI+ (Sep 21, 2011 index = 100)



Source: Bloomberg & BBVA Research

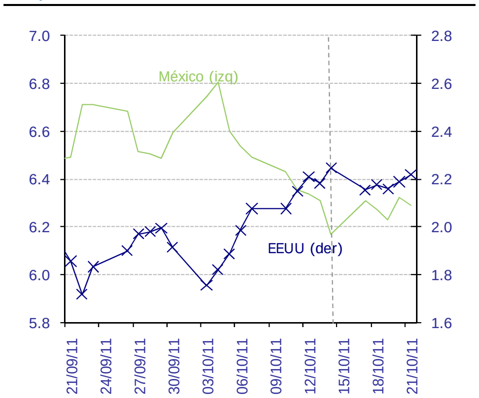
Chart 10
Risk: 5 year CDS (Sep 21, 2011 index=100)



Source: Bloomberg & BBVA Research

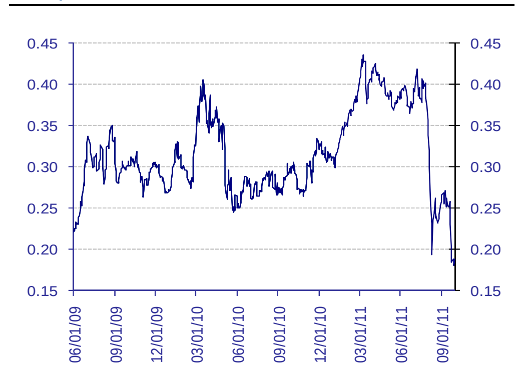
Upswing in Treasury rates and fall in rates in Mexico toward the end of the week due to forecasts of a solution to the European crisis

Chart 11
10-year interest rates*, last month



Source: Bloomberg & BBVA Research

Chart 12
Carry-trade Mexico index (%)

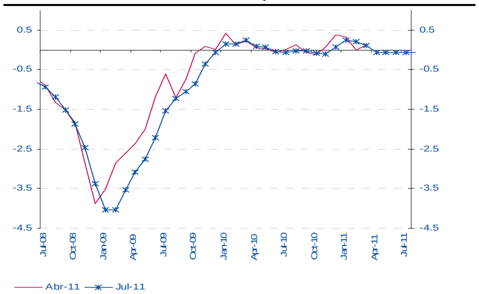


Source: BBVA Research with data from Bloomberg

Activity, inflation, monetary conditions

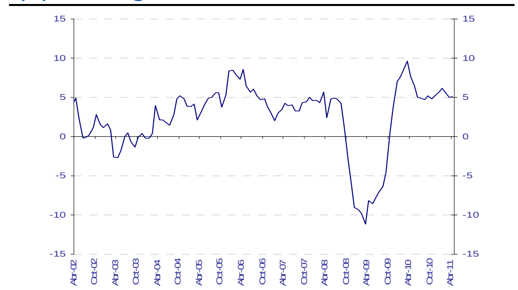
Output holds positive performance, situation indicators point to 3Q11 near to 2Q quarterly rate

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.

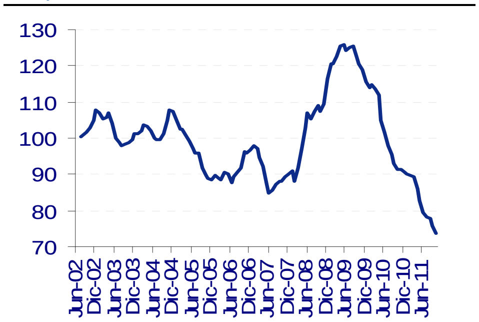
Chart 14
Advance Indicator of Activity (y/y % change)



Source: INEGI

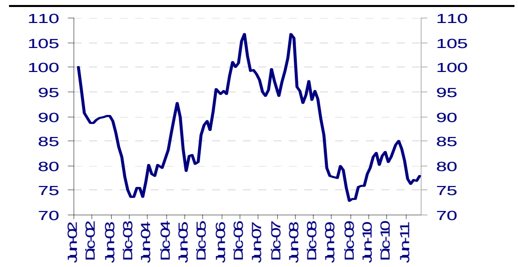
Recent inflationary surprises have been downward, while those concerning economic activity have been mixed.

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.

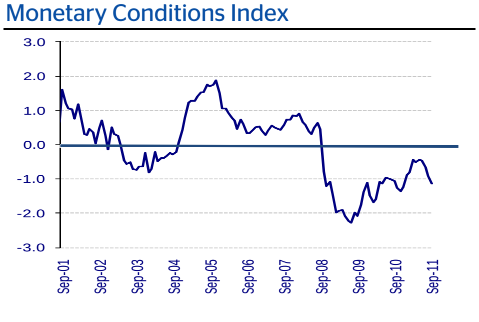
Chart 16
Activity Surprise Index (2002=100)



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.

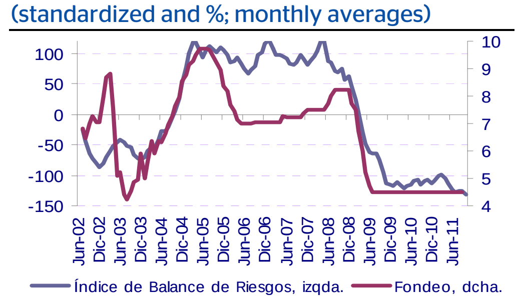
Monetary Conditions relax due to recent exchange rate depreciation

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