BBVA | RESEARCH

Weekly Watch

Mexico

November 11, 2011

Economic Analysis

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Next week…

… watching for volatility

Although no domestic economic data are due does not mean next week will be lacking news to watch out for. With regard to economic output, the US manufacturing output data for October will be important. We expect this to maintain its trend of increases (forecast: 0.2% m/m; previous: 0.2% m/m) which is positive for Mexico if, in addition and as expected, growth comes especially from durable consumer goods production which has a knock-on effect for the Mexican economy.

Today saw the release of industrial output data for September, showing growth of 1.7% m/m, far above forecasts. With this information, the MICA-BBVA Research model forecasts growth in the 3Q11 of 1.3%, 3 points above last week and in line with annual growth of 3.8% for 2011.

The BBVA Research "Mexico Watch" magazine was released this week where we analyze the current situation and set out forecasts for the main macroeconomic and financial variables

Market Analysis

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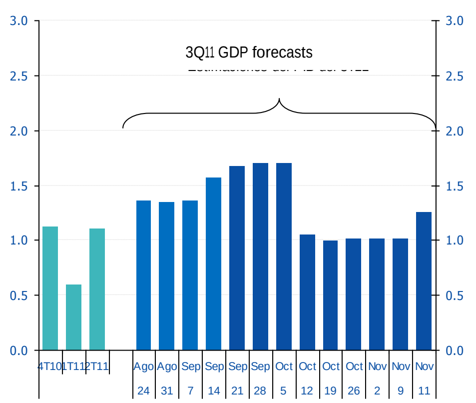
Falls in domestic markets in the face of global risk aversion, but with a better relative performance than advanced markets

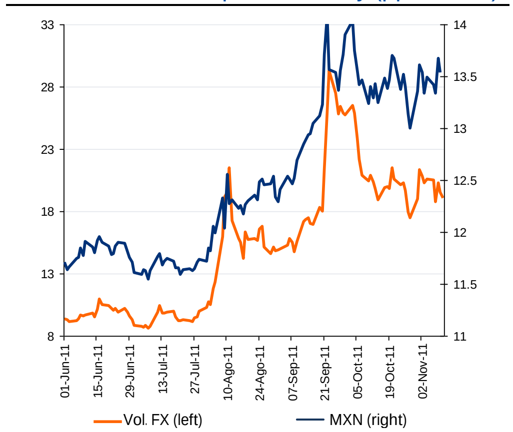
The lack of forceful decisions continues to feed fears of a vicious circle of sovereign debt affecting growth that could lead to contagion to other parts of the zone. However, the relatively more favorable news from the U.S. (jobs) had a favorable effect on Mexican markets.

Chart 1
BBVA-MICA: forecast for Mexican GDP 3Q11 (q/q % change)



Source: BBVA Research

Chart 2
1 month and MXN implied volatility (ppd and %)



Source: BBVA Research and Bloomberg

(continued from front page)

BBVA Research "Mexico Watch"

Economic Analysis

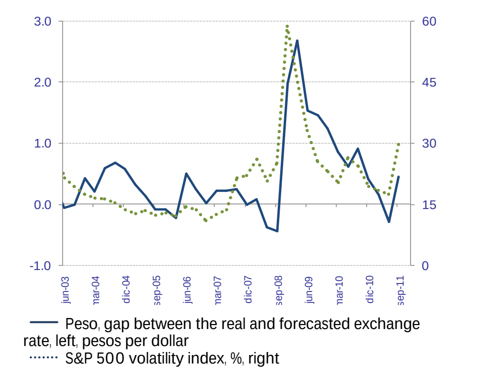
With regard to **economic output**, we estimate that with an external scenario sensitive downward risks, Mexico is set to maintain an average growth of 3.5% for 2011-12. Negative impacts for our economy cannot be rule out however if sustained rises in the global risk premium occur and the European risk scenario affects the US, reducing demand from the country to lower levels in 2012 than in 2011. Our baseline is growth of 3.8% and 3.3% in GDP for 2011 and 2012 respectively, somewhat lower than forecasts from last quarter.

In the global scenario, and especially the US, despite improved growth over the period, the temporary fix for fiscal consolidation, the doubts surrounding the real estate sector and a job market with an unchanging unemployment rate, lead to a downward outlook bias for 2012 remaining. In Europe, the Eurozone is again seeking another final permanent solution so that Greek debt insolvency does not lead to other sovereign liquidity problems becoming insolvencies and banking lending rate difficulties becoming a credit restriction leading to a recession in Europe in 2012.

In this setting, high-enough demand pressures are not foreseen so as to fear an increase in **inflation forecasts**, something the Bank of Mexico has been proving with successive changes in its releases with a more accommodating tone pointing to a cut in the lending rate at its next meeting on December 2. We forecast inflation to come in at 3.3-3.4% at the end of 2011. For 2012, the slowdown in output should be in line with headline inflation remaining around 3.5% for the second year running.

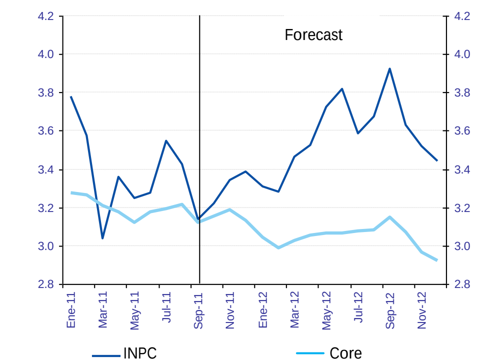
On currency markets, bursts of global volatility driving the peso down cannot be ruled out. However, as long as these events do not derail positive growth forecasts for Mexico or put the commitment to deficit and public debt target in jeopardy, it would seem reasonable to expect the exchange rate to remain at levels near 12.0-12.5 ppd on average throughout coming quarters.

Chart 3
Global volatility and Mexican peso
US stock market volatility and a gap between the real exchange rate (pesos per dollar) and that in line with output and inflation forecasts for Mexico vs. US



Source: BBVA Research with IMSS data

Chart 4
Inflation scenario 2011-2012
(y/y % change)



Source: BBVA Research with Banxico and INEGI data

Markets

Market Analysis

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With no forceful decisions in the structure of the euro zone, tensions will continue

The possibility of a recession has increased, and with it the risks of a vicious circle heightening the fiscal crisis in the euro zone and spreading contagion within it. This was suggested by the European Commission when it revised down the euro zone's growth prospects (from 1.5% to 0.8% for 2012). The lack of credible fiscal measures in Greece and Italy has prompted changes in government in these countries, and led to historically high levels of financial costs: 10-year bonds in Italy reached 6.79% (500 bps above the German Bund and the level at which Greece, Ireland and Portugal were bailed out). The sovereign debt situation obscured the figures from China (sales, industrial output and inflation) pointing to a "healthy" slowdown and employment data in the U.S. suggesting signs of a recovery.

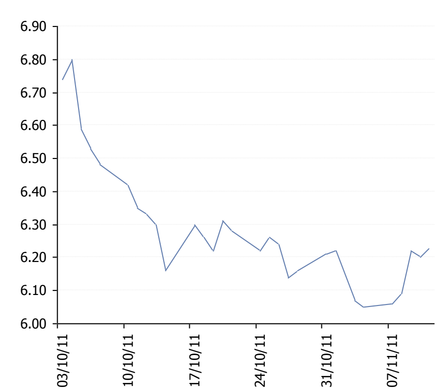
Moderate weekly depreciation in the MXN, albeit less marked than that for G10 currencies against the USD...

The MXN fell over the week by 0.36%, thereby correcting the fall seen at the start of the week on Friday; meanwhile, implied volatility (1m) remains at high levels since September. However, the G10 currencies (except the JPY, CD and GBP) fell back even more against the USD. The difference in growth news in the US (job figures) and more pessimistic news in the Eurozone could be behind this short-term performance. We forecast the MXN to keep trading in ranges between 13.15 and 13.6 over the week.

Volatility in fixed-income dominates.

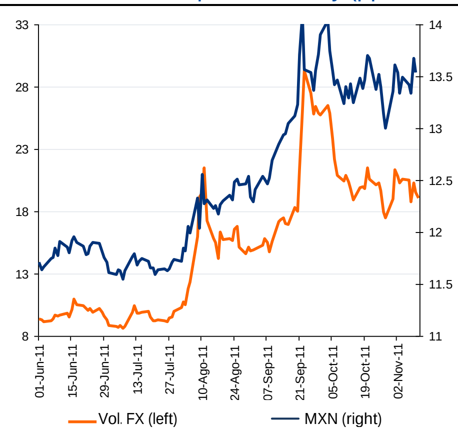
Despite the correlation with the move in global risk premiums decreasing, news and events from Europe continue to set the curve trend. We continue to forecast the monetary policy, controlled inflation and economic uncertainty will end up weighing more on the market. The reaction to the tragic accident leading to the death of the Minister of the Interior will need to be monitored. Market over-reaction could even lead to the market assuming Banxico will wait to lower the lending rate (although it is very early to take this into account).

Chart 5
10 year Bond interest rate (%)



Source: Valmer

Chart 6
1 month and MXN implied volatility (ppd and %)



Source: BBVA Research and Bloomberg

Market Analysis
Equities

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Technical Analysis

IPC Stock Market Index

The IPC has not managed to lower over-purchasing readings in short-term oscillating indicators or close the spread between 10- and 30-day rolling averages. This keeps the risk of short-term profit-taking high with supports at 36,000 and 35,600 pts. We have therefore maintained a low short-term investment level. If the market does not show profit-taking and the upswing is maintained, the entry mark will come when the weekly high is broken, currently at 37,350 pts. We believe that, if this break is seen, the market could continue up to 38,000 pts, then showing major resistance since this is the maximum from April. We would more likely be sellers at these levels.

Previous Rec.: We are likely to see the market start trading in lateral ranges between 36,000 and 37,000 pts over coming sessions.

Source: BBVA Bancomer, Bloomberg

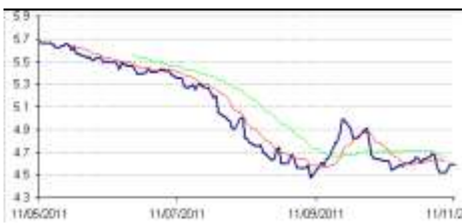
MXN

A week with a neutral balance for the dollar which continues to trade in the negative short-term tranche. If it continues to trade in the high part of this tranche, we maintain a downward outlook for the dollar to floor levels at MXN13.20 and MXN13.00.

Previous Rec.: If resistance is met at this level, we continue to see a move to the lower section of the tranche, toward MXN13.00.

Source: BBVA Bancomer, Bloomberg

3Y M BOND

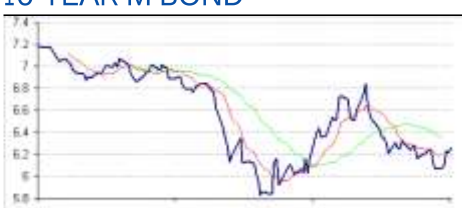


3 YEAR M BOND: (yield): Return to the 4.5% support. It could mark a double bottoming-out over this level. We expect a bounce toward levels around 4.7% and then 4.9%. Stop Loss under 4.5%.

Previous Rec.: May seek a floor at 4.5%.

Source: BBVA Bancomer, Bloomberg

10 YEAR M BOND



10-YEAR M BOND: (yield): Bounce which sets the bond above the 10-day rolling average. If it breaks 6.35%, it could set a trend change and seek 6.8%.

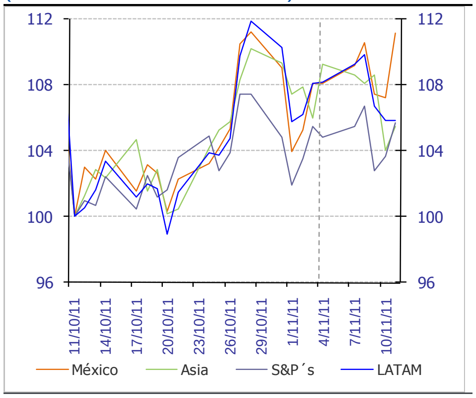
Previous Rec.: Initial support at 6% but could seek a subsequent floor up to 5.8%.

Source: BBVA Bancomer, Bloomberg

Markets

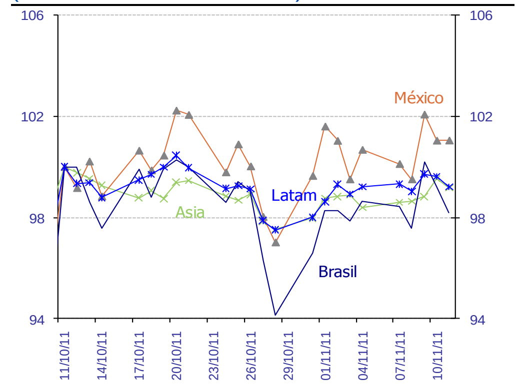
The approval of austerity measures in Italy and the higher-than-expected increase in US consumer confidence led to gains on stock markets and a slight strengthening in the peso.

Chart 7
Stock Markets: MSCI Indices (October 11, 2011 index=100)



Source: Bloomberg & BBVA Research

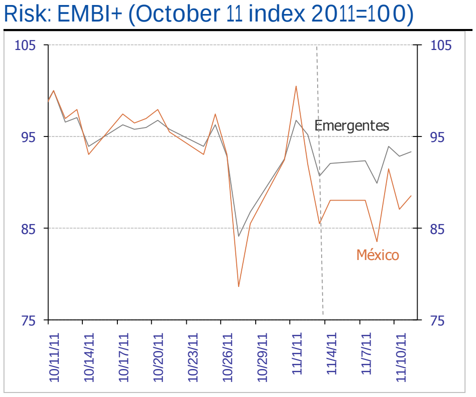
Chart 8
Foreign exchange: dollar exchange rates (October 11, 2011 index=100)



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

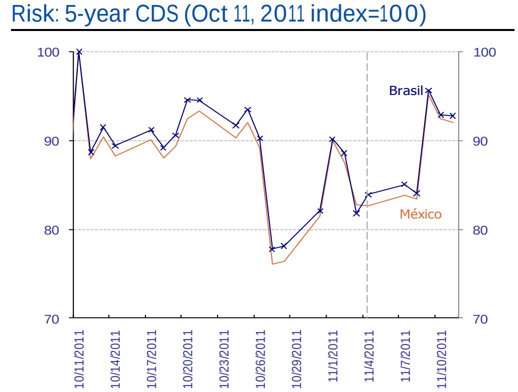
Increase in risk aversion over the week after the downward revision to growth forecasts in the Eurozone

Chart 9
Risk: EMBI+ (October 11 index 2011=100)



Source: Bloomberg & BBVA Research

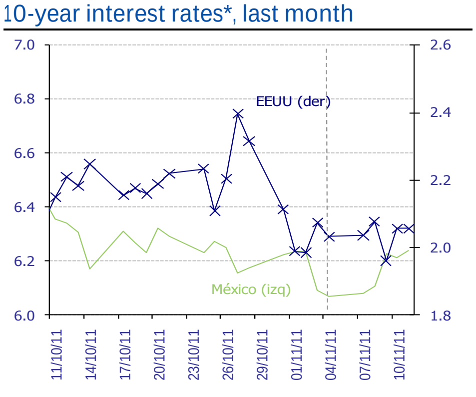
Chart 10
Risk: 5-year CDS (Oct 11, 2011 index=100)



Source: Bloomberg & BBVA Research

Increase in interest rates in Mexico over the week in light of risk aversion episodes.

Chart 11
10-year interest rates*, last month



Source: Bloomberg & BBVA Research

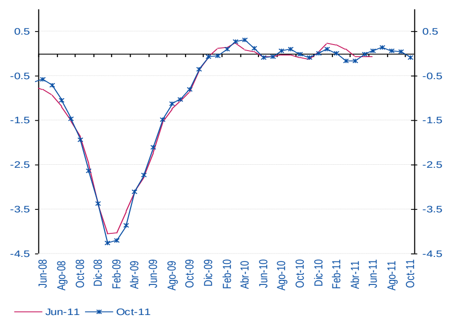
Chart 12
Carry-trade Mexico index (%)

Source: BBVA Research with data from Bloomberg

Activity, inflation, monetary conditions

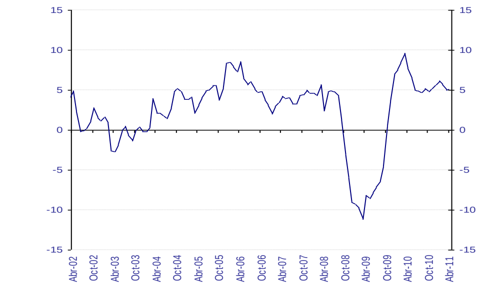
Output holds positive performance, situation indicators point to 3Q11 with quarterly rates around 1%

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.

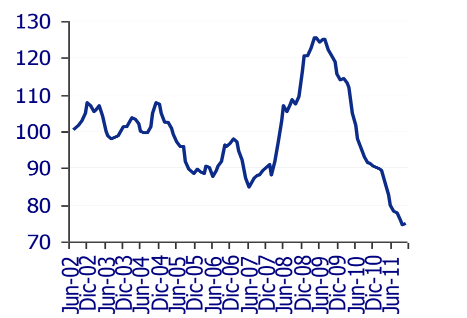
Chart 14
Advance Indicator of Activity (y/y % change)



Source: INEGI

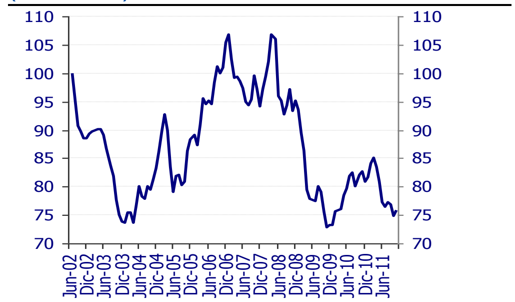
Recent inflationary surprises have been downward, while those concerning economic activity have been mixed.

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.

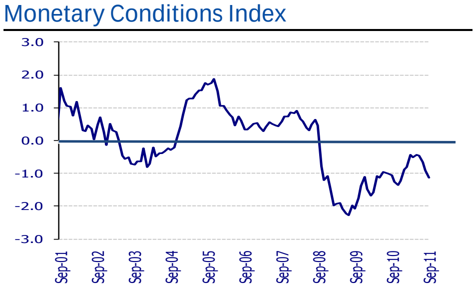
Chart 16
Activity Surprise Index (2002=100)



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.

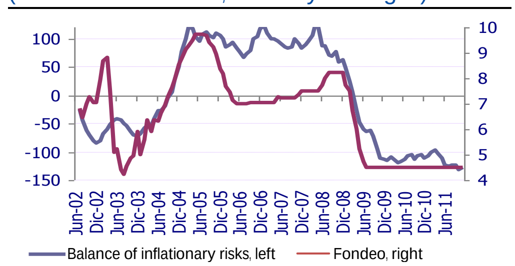
Monetary Conditions relax due to recent exchange rate depreciation

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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