BBVA | RESEARCH

Weekly Watch

Mexico

November 25, 2011

Economic Analysis

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Next week...

... Banxico decides

Banxico's Board decision on the Interbank lending rate will be released on Friday, December 2. The rate has remained at 4.5% since July 2009 and we highly expect the meeting will lower it to 4.25% despite the recent fall in the exchange rate. Although there was a fall and increased volatility in the exchange rate last week, the risks to economic output are far from behind us. In addition, we should remember that the exchange rate is neither a target nor a tool of Mexican monetary policy, the aim of which is to ensure price stability with a permanent inflation target set at 3%. Nonetheless, there is a risk, which we see as low, that the exchange rate levels seen since September could worsen the risk balance on prices with an increase costs of imported commodities. In this way, at BBVA Research we remain convinced that Banxico will lower the rate on December 2. However, the likelihood of it delaying the rate cut until the next meeting on January 20 cannot be ruled out. Even if it does not cut the rate on Friday 2, this does not invalidate the scenario of a future rate cut given the current risk balance to output and prices (see page 2).

Finally, next week also sees the release of October public balances for the federal government (see page 2)

Market Analysis

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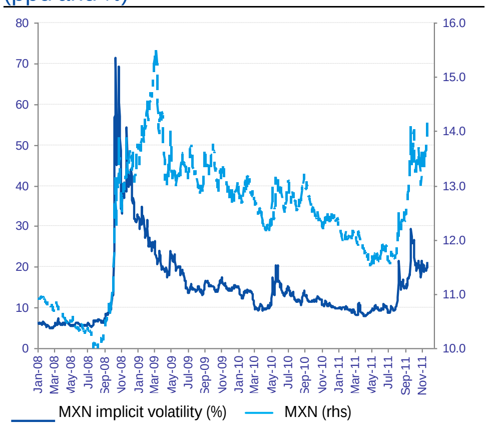
Skepticism rules in the face of European governance this week

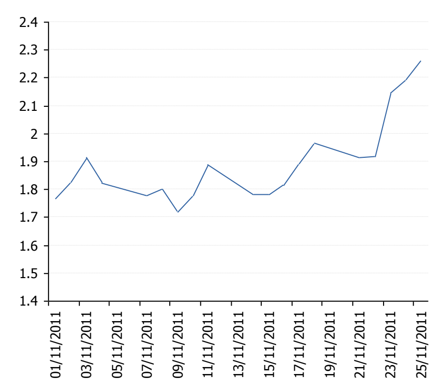
The week is set to be filled with events relating to the European sovereign risk: 1) November 28, US summit with European countries, 2) November 29, Eurogroup and 3) November 30, Ecofin. Expectations for a solution seem to be low after it was made known that talks will not include the ECB's role linked with the cold reception in Germany to the proposed issuance of Eurobonds after the publication of the European Commission's Green Paper.

Chart 1
Exchange Rate and implicit volatility (ppd and %)



Source: BBVA Research and Bloomberg

Chart 2
10-year German bonds (%)



Source: BBVA Research and Bloomberg

Calendar: Indicators

Economic Analysis

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1-day interbank lending rate (Friday, December 2)

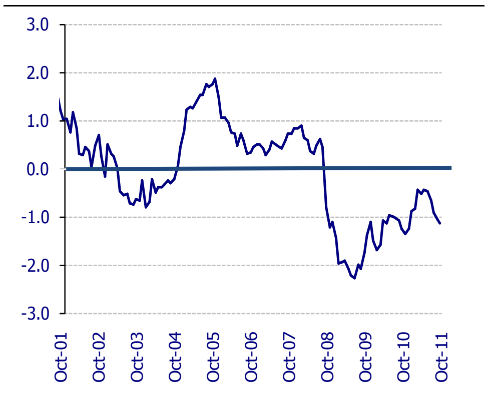
Forecast: 4.25%	Consensus: 4.5%	Previous: 4.5%

Recent economic output data in Mexico have moved markets up. Nevertheless, downward risks for overseas issues show no sign of improving. GDP growth in the Q3 in the US was revised down by 0.5%, while different indicators point to European growth having stalled. In addition, the lack of agreement among European authorities on how to solve the debt crisis is putting pressure on global financing conditions. With regard to inflation, despite the recent bounce, it should remain contained given the lack of demand pressures. In this scenario, the tone of Banxico's release has shown clear easing since last August, restating the lack of any knock-on effect for the exchange rate on prices and inflation forecasts, as well as the expectation that increases in the exchange rate are temporary. This leads us to believe that upward risks for inflation are limited. In this way, we believe that with the analysis of all risk factors and the emphasis in its release, Banxico will cut the monetary policy rate. If not, we expect to see a sign in the release as to the factors behind its decision to maintain the pause.

Public Finances in October (Wednesday, November 30)

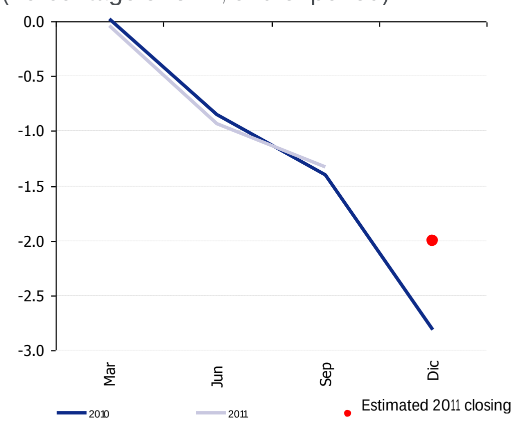
Public finance data for October will be released next week. The accumulated public sector federal budget to 3Q11 is -1.3% of GDP. Therefore, in the last quarter of the year, the government will have 0.7% of GDP to wield above its revenue and, in this way, attain its target of a budget balance at the end of the year of -2% of GDP. We believe it will attain this easily without deviations involving higher debt. In the year to date, budget revenue has increased by 6.3% y/y in real terms, supported by the growth in oil revenue due to the high oil price, a 2.9% increase in tax revenue boosted by higher ISR (income tax) and IETU (flat rate tax on business operation) collection (10.6% and 2.6% y/y). Nonetheless, the slightly disappointing results from VAT collection (2.6% y/y) should be mentioned. With regard to non-tax revenue, there is also higher income from non-oil organizations and businesses (8.4% y/y) boosted by employment growth (IMSS) and electricity sales (CFE). We believe the Mexican economy remains on a disciplined fiscal path although it is supported by high oil prices. In addition, there are downward risks linked to the growth outlook.

Chart 3
Monetary conditions index



Source: BBVA Research.

Chart 4
Budget balance trajectory
(Percentage of GDP, end of period)



Source: BBVA Research with SHCP and INEGI data

Markets

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Coming week is key for performance in global risk premiums

The week is set to be filled with events relating to the European sovereign risk: 1) November 28, US summit with European countries, 2) November 29, Eurogroup and 3) November 30, Ecofin. Expectations for a solution seem to be low after it was made known that talks will not include the ECB's role linked with the cold reception in Germany to the proposed issuance of Eurobonds after the publication of the European Commission's Green Paper. The need for quick-to-implement solutions is becoming ever more pressing since the chance of contagion continues to cross borders, leading to Moody's indicating the previous week that France's credit rating may be cut, as well as the scant demand in the German Bund auction. This could be a sign of lower appetite for assets in euro due to doubts surrounding their sustainability. The cut in France's rating is far from trivial as it may have negative effects on the EFSF rating and, therefore, on its ability to issue debt at competitive rates. The lack of agreement continues to charge volatility and put pressure on the values on different risk assets in the short term.

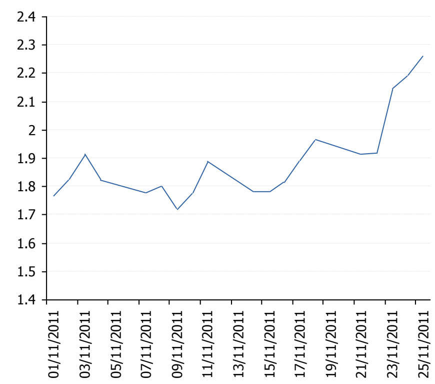
A week of major pressure on curves

The MBOND and TIIE curve saw a major loss over the week. MBOND yields increased by an average 30bp, with the short and medium sections being hit the most. The reasons behind this were: 1) The devaluation in the MXN, diluting expectations that Banxico would reduce the lending rate next week, 2) high seasonal inflation, and 3) an intense worsening in sovereign and bank financing indicators in Europe (even 10-year German Bunds increased 30bp while euro basis swaps and interbank spreads continue to come under pressure).

USDMXN closed above 14.20 in the week prior to Ecofin

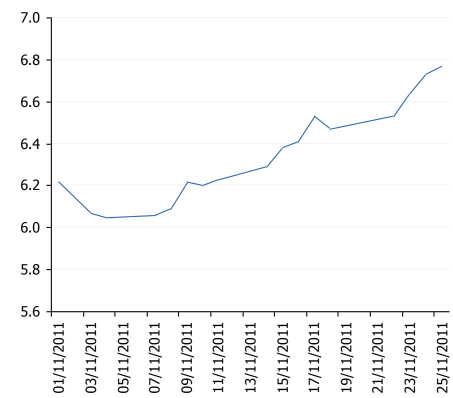
The trail of mostly negative news over the week in the EMU led to a general decline in risk assets on global markets which, in turn, led to a fall of over 3.7% in the MXN. This was also accentuated by the lack of fiscal agreement in the US and the risks the latter represents for the country's economic cycle as well as its credit rating. Locally, curves continued to price in an ever more dovish stance from the Bank of Mexico in the face of the major fall in the currency, in addition to surprise upward inflation data. Nonetheless, this is far from being a positive factor for the MXN and while the European risk premiums remain high, we cannot see the necessary drivers for the MXN to return to levels more in line with fundamentals. In this sense, we continue to forecast a wide trading range in the short term without ruling out an attempt to test the 14.50 zone. The spotlight will be on the Ecofin and Eurogroup meeting with good news possibly offering a respite. However, a strong definitive solution is required for the MXN to again be strong.

Chart 5
10-year German bonds (%)



Source: BBVA Research and Bloomberg

Chart 6
10-year Mexican bond (%)



Source: BBVA Research and Bloomberg

Market Analysis
Equities

Technical Analysis
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Technical Analysis

IPC Stock Market Index

The IPC ended the week right on the 50% backward movement level in the Fibonacci model. Although the current market trend is negative, we believe we could see a bounce at the start of next week due to the buy opportunities that may appear in issuers having experienced major punishment and having hit major support levels (Amx, Tlevisa, Gfnorte, Gmexico). We do not believe that this bounce is strong enough to carry the market on an upward trend again. However, we do see it as a chance to make rapid gains or reduce losses in some positions. The zone where this reaction would again meet resistance would be around 36,000pts.

Previous Rec.: We believe that there is still a high likelihood of it seeking out the 35,600pts level where it would hit a more important support - the area where the 30- and 200-day rolling averages come together.

Source: BBVA Bancomer, Bloomberg

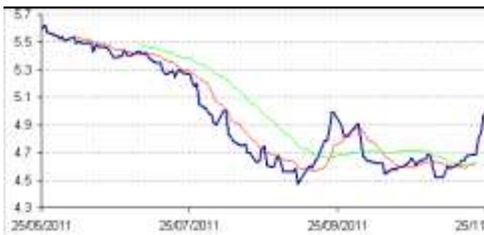
MXN

Major break over the week with the dollar hitting above MXN14.00 to see a new yearly maximum with levels not seen since March 2009. Very high over-buys on short-term oscillating indicators, although major resistance comes in up to MXN14.50. Supports at MXN14.00 and MXN13.85 where we expect it to adjust in the short-term.

Previous Rec.: The bounce could persist to the MXN13.85 zone where it would hit the second standard deviation with a return to that from two months ago.

Source: BBVA Bancomer, Bloomberg

3Y M BOND

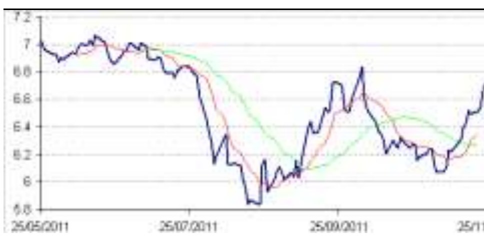


3 Y M BOND: (yield): Maintaining its upward move and hitting resistance at 4.9%. Here, we see profit-taking as highly likely given the over-buy and short-term resistance. Initial support level at 4.7%. A move above 5% sets the next target at 5.3%.

Previous Rec.: The bounce could persist with a target at 4.9% and support at 4.6%.

Source: BBVA Bancomer, Bloomberg

10 YEAR M BOND



10-YEAR M BOND: (yield): Maintaining bounce and hitting the 6.8% zone. We expect profit-taking toward the 6.4% zone. A move above 6.8% sets the next resistance up to 7%.

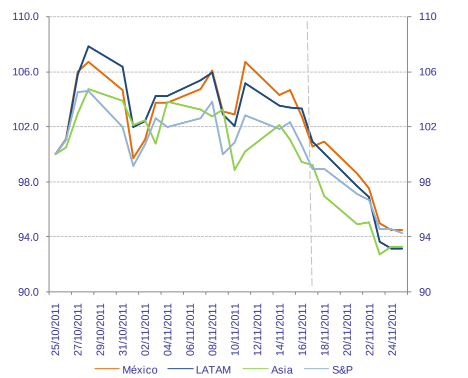
Previous Rec.: Important resistance up to 6.8% with support at 6.3%.

Source: BBVA Bancomer, Bloomberg

Markets

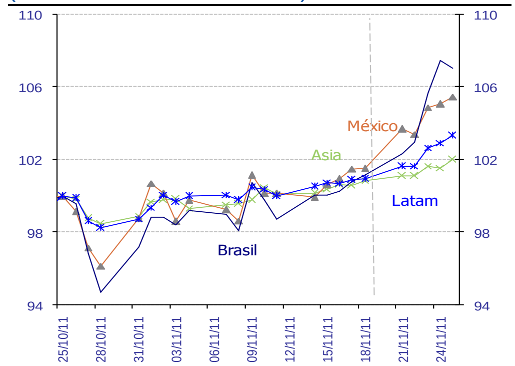
The different positions at authorities in European countries on solving the debt crisis and the low demand for German debt led to stock market losses over the week. The peso depreciated to maximum levels for the year

Chart 7
Stock Markets: MSCI Indices
(October 25, 2011 index=100)



Source: Bloomberg & BBVA Research

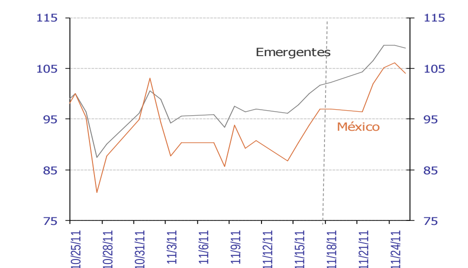
Chart 8
Foreign exchange: dollar exchange rates
(October 25, 2011 index=100)



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

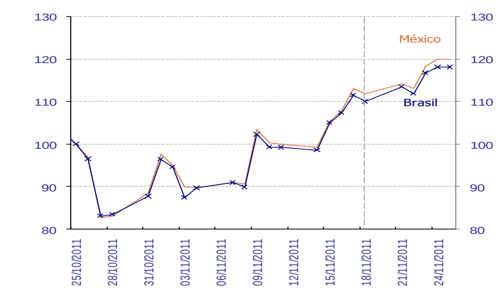
Tension in Europe, the cut in Belgium's credit rating and versions on Greece asking investors to accept bigger losses increase global risk aversion

Chart 9
Risk: EMBI+ (October 25 index 2011=100)



Source: Bloomberg & BBVA Research

Chart 10
Risk: 5-year CDS (Oct 25, 2011 index=100)

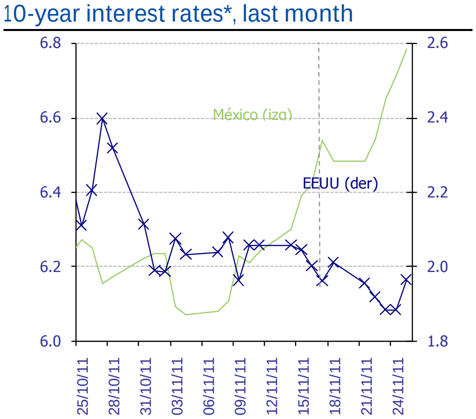


Source: Bloomberg & BBVA Research

Increase in Mexican interest rates and a decline in US rates over the week in line with the increase in the risk aversion

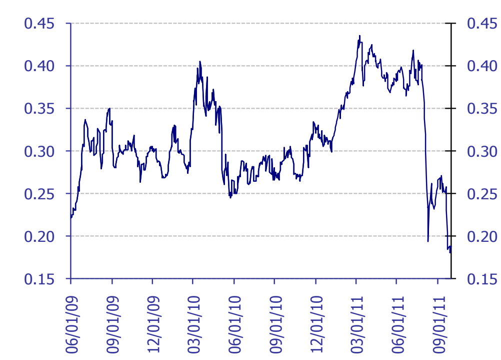
Output holds positive performance, situation indicators point to 3Q11 with quarterly rates around 1%

Chart 11
10-year interest rates*, last month



Source: Bloomberg & BBVA Research

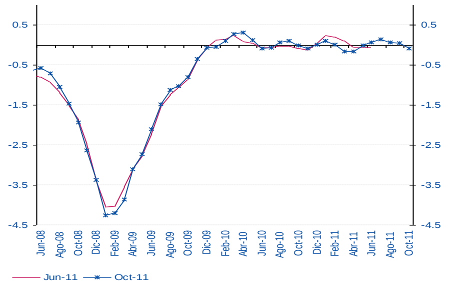
Chart 12
Carry-trade Mexico index (%)



Source: BBVA Research with data from Bloomberg

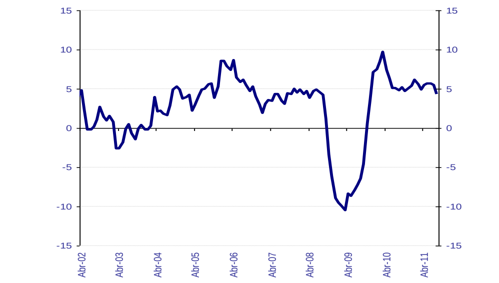
Activity, inflation, monetary conditions

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.

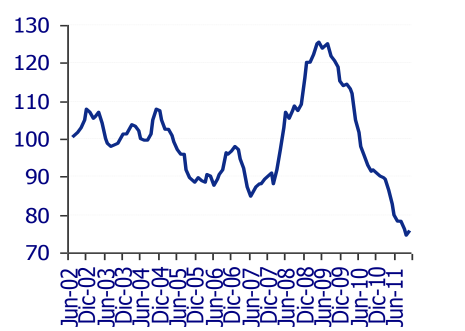
Chart 14
Advance Indicator of Activity (y/y % change)



Source: INEGI

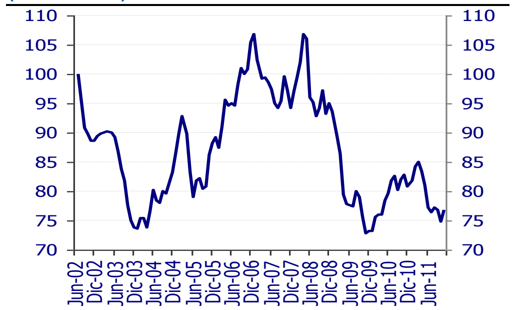
Recent inflationary surprises have been downward, while those concerning economic activity have been mixed.

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.

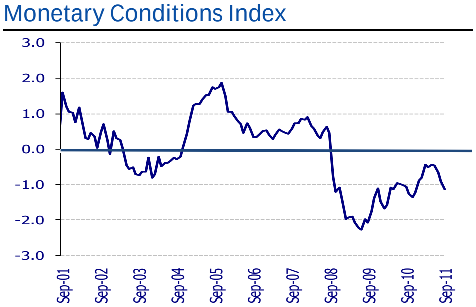
Chart 16
Activity Surprise Index (2002=100)



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.

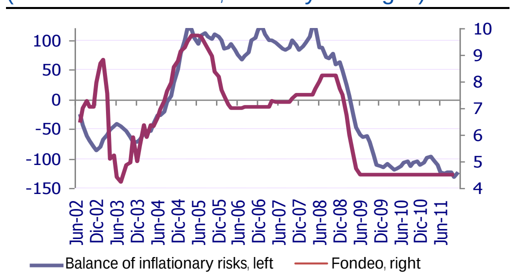
Monetary Conditions relax due to recent exchange rate depreciation

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

IMPORTANT DISCLOSURES

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