Weekly Watch

Mexico

Next week...

January 20, 2012

Economic Analysis

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Will bi-weekly inflation in the first half of January come in unchanged?

Next week sees the release of the first bi-weekly inflation figures of the year which we believe will surprise markets (which expect a 0.25% rise as opposed to the -0.05% estimate from BBVA Research) with a downturn. The 47.4% price cut in fixed line phone calls to cell phones came in at the start of the year at the major telephone company. Alongside this downswing in prices sits the disappearance of the tax on car ownership in some states and the seasonal fall in tourist package services. In all, these price movements will only compensate downwards the price pressures on processed foods and agricultural products affected by high corn prices in the country and those on electricity prices - moving up due to the rise in energy prices around the world and the lower peso. These are all relatively short-term price changes which do not alter the general outlook for inflation remaining in the high part of Banxico's range for 2012, with upward pressure due to the rise in some import prices although without general pressures from demand.

Market Analysis

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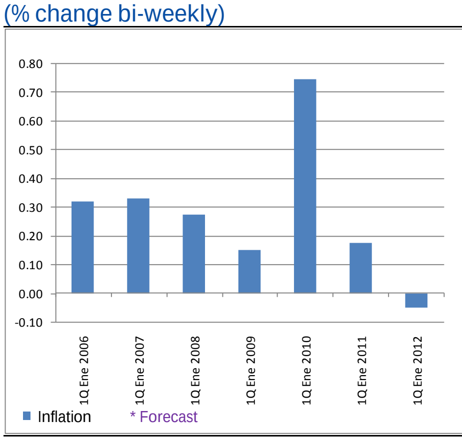
Banxico's "wait and see" note will continue to support the curve while the MXN's performance will be dominated by global factors

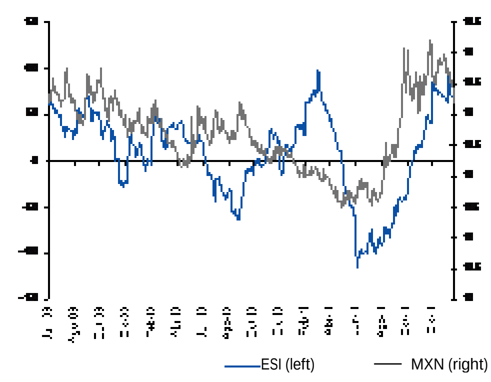
The curve is at levels about to break through the lower limit in our "fair value" estimates. The short tranche reflects a prolonged monetary pause while the medium part has lost curve appeal. We expect the 10 year bond to reach target levels of 5.95% and then correct up. In turn, the soft Banxico position will support the curve and limit the extent of any upward trend. We do not see today's (Friday) decision having major effects on the MXN. Firstly, the decision taken was expected and the scenario set out in the release is not different to that from other meetings; secondly, the MXN continues mainly to respond to global factors

Chart 1
Inflation for the first two weeks of the year (% change bi-weekly)



Source: BBVA Research and INEGI

Chart 2
Economic surprise index for the US and MXN



Source: BBVA Research and Bloomberg on Friday

Calendar: Indicators

Economic Analysis

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Inflation for the first two weeks of January (Tuesday 24, January)

Forecast: -.05% bi-weekly (3.55% y/y)	Consensus: 0.25% bi-weekly.	Previous: 0.82% m/m

Headline inflation will fall -.05% bi-weekly thanks to a 0.2% bi-weekly contraction in the core component which will be favored by a negative inflation rate in the other services component due to the aforementioned factors and moderate rises in housing and education prices. Non-food goods will rise moderately since the start of the sale season will partially offset the effects of the exchange rate. In turn, processed food prices will continue to see domestic corn market pressures. Nonetheless, they will likely fall in annual terms due to the statistical effect linked to the IEPS (special tax on products and services) increase on tobacco in the first two weeks of 2010. Non-core inflation will increase since on top of the seasonal rise in agricultural prices will be pressures on livestock and energy products. Inflation will end 2012 within Banxico's range. However, it may go over 4% at times given the combination of the exchange rate shock and continued pressures in commodity prices.

IGAE (Tuesday 24 January)

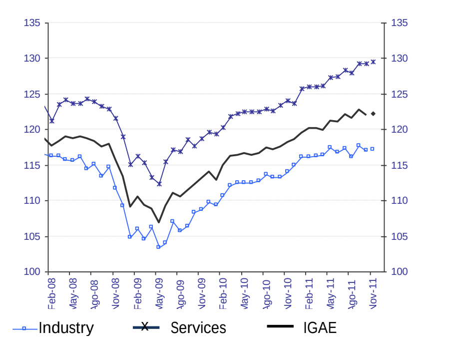
Forecast: 0.15% m/m (3.3% y/y)	Consensus: N.A.	Previous: -0.60% m/m (3.8% y/y)

Retail Sales (Thursday 26 January)

Forecast: 0.20% m/m (3.5% y/y)	Consensus: N.A.	Previous: -0.10% m/m (3.0% y/y)

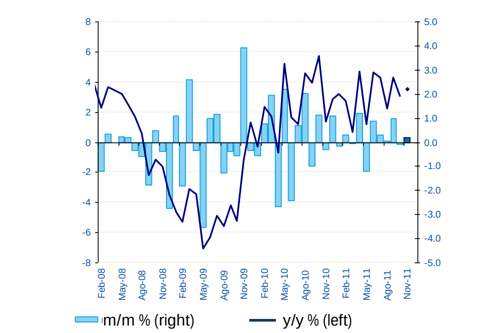
In terms of the IGAE, we believe that after the upturn in industrial output (0.1% m/m, -0.5% previous month), services will also see growth after none in the previous month. Taking into account these marginal improvements, output should come in 0.15% higher in November. We see a similar situation for retail sales which after the -0.1% fall in October we expect to see improvement of around 0.2% in November. In both instances, the expected improvement is linked to good formal employment figures (0.4% monthly in the Oct-Dec quarter vs. 0.3% in the previous quarter). These slightly positive figures are in line with a scenario of output moderation in 4Q11 in comparison to 3Q11.

Chart 3
IGAE, SA (2003 Indices=100)



Source: BBVA Research with INEGI data

Chart 4
Retail Sales (% change y/y and m/m)



Source: BBVA Research with INEGI data

Markets

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Some Banxico release areas affecting fixed income...

The central bank's release maintained its soft position and mentioned the balance of risks for global and domestic growth continuing to deteriorate due to the turmoil in Europe. Further, it highlighted persistent structural problems in the US despite recent indicators showing a slight recovery. In Mexico, the output gap is closing at a slower-than-expected rate. With regards to inflation, the statement set out a neutral balance of risks and highlighted the recent upturn will undoubtedly be temporary. It also underlined that there is no evidence of exchange rate impacts but the market could start to discount a relaxation in monetary policy if the MXN rises over 3.5%. Broadly, Banxico's position is "wait and see" in terms of a rise or fall in the peso, a change in inflation outlook and any sign pointing to a recovery/slowdown in economic activity.

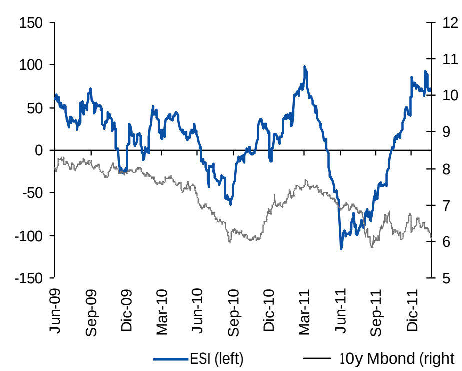
...the "wait and see" strategy will continue to support the curve...

The curve is at levels about to break through the lower limit in our "fair value" estimates. The short tranche reflects a prolonged monetary pause while the medium part has lost curve appeal. We expect the 10 year bond to reach target levels of 5.95% and then correct up. In turn, the soft Banxico position will support the curve and limit the extent of any upward trend. We will continue to plot range strategies until a scenario arises leading to a cut in the lending rate. Given global market volatility continues to affect domestic yields, we believe the prevailing strategy for the coming two months will be: taking on in the short section of the TIIE (2Y and 3Y) with rates fluctuating in the range of 5.15%-4.90% and 5.38%-5.10% respectively. Maintain long positions in the M2021 (5.95% target).

...meanwhile the USDMXN will continue to react to global factors

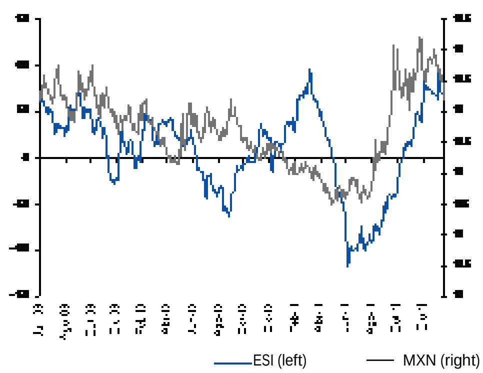
We do not expect Friday's decision to have a major effect on the MXN. Firstly, the decision taken was already expected and the scenario set out in the statement is not different from that at prior meetings. Secondly, the MXN continues to react mainly to global factors and has recently shown greater sensitivity to US economic data. We continue to believe that the MXN will correct some of the recent gains made from technical factors and from the series of meetings to be held in Europe next week. Nevertheless, we should not forget the trend to a soft position has not changed and that the likelihood of flexibility in the short-term could slightly affect the MXN.

Chart 5
Economic surprise index for the US and 10Y MBond (%)



Source: BBVA Research and Bloomberg, information from Friday

Chart 6
Economic surprise index for the US and MXN



Source: BBVA Research and Bloomberg, information from Friday

Market Analysis
Equities

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Technical Analysis

IPC Stock Market Index

The IPC managed to bounce up over the week, bettering the highs on US markets. Although it did not managed to break up through 37,600pts, we believe a possible short-term return will respect the 36,900pts support where the 30-day rolling average sits. This may help the over-sell of AAA issuers such as Amx, Femsa and Tlevisa which could start to pick up at any time.

Previous Rec.: Although the triangle signal would produce a target of around 40,000pts, we believe 38,700pts would be a more realistic target, 3% above current resistance.

Source: BBVA Bancomer, Bloomberg

MXN

Dollar maintains downward move throughout the week. It is already trading with over-sell on oscillating indicators and below the 2nd standard deviation in the 60-day regression. We could see technical bounces albeit limited to the MXN13.40 range. The downward movement would be limited to MXN13.00 under the MXN13.20 level.

Previous Rec.: Only a downward breakthrough of this minimum would mark a trend change to negative with a new target at MXN13.00.

Source: BBVA Bancomer, Bloomberg

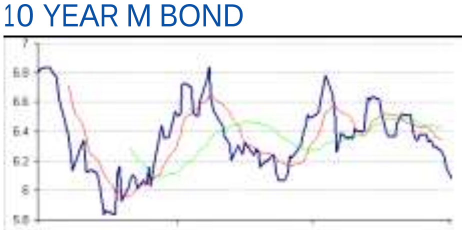
3Y M BOND

3-YEAR M BOND: (yield): Return over the week which sets the bond below the 30-day rolling average. This break marks a return to the 4.7% zone.

Previous Rec.: The oscillating indicators a new upward bounce. Only a downward break through the 30-day rolling average would rule out this outlook.

Source: BBVA Bancomer, Bloomberg

10 YEAR M BOND



10-YEAR M BOND (yield): Major downward move taking the bond to the 6.1% level from where it had seen a major bounce. We believe it could halt the fall at this level.

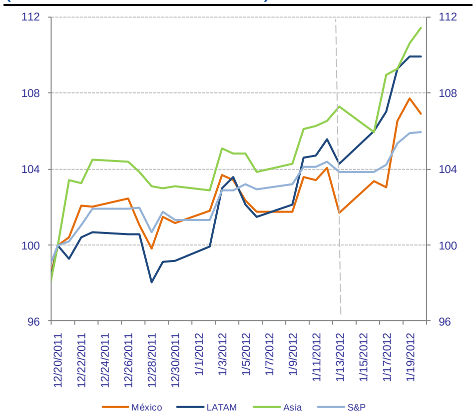
Previous Rec.: The bond trades in a triangle formation and only an upward break to 6.62% would produce a purchase signal.

Source: BBVA Bancomer, Bloomberg

Markets

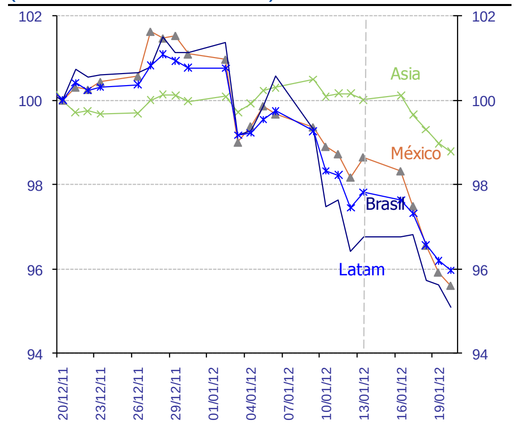
Manufacturing output, employment and housing data in the US, as well as lower interest rates in Europe, lead to gains on stock markets over the week, alongside higher currencies

Chart 7
Stock Markets: MSCI Indices
(Dec 20, 2011 index = 100)



Source: Bloomberg & BBVA Research

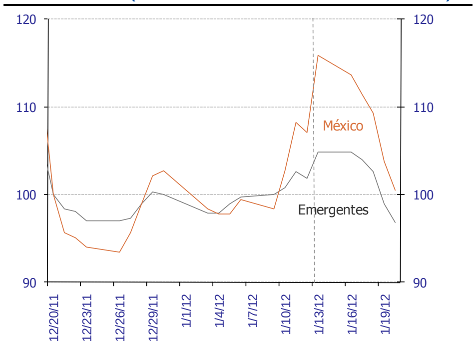
Chart 8
Foreign exchange: dollar exchange rates
(Dec 20, 2011 index = 100)



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

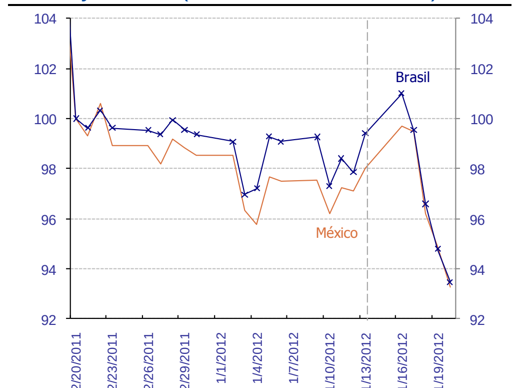
Fall in risk aversion in the face of sovereign bonds seeing lower interest rates in Europe

Chart 9
Risk: EMBI+ (December 20, 2011 index=100)



Source: Bloomberg & BBVA Research

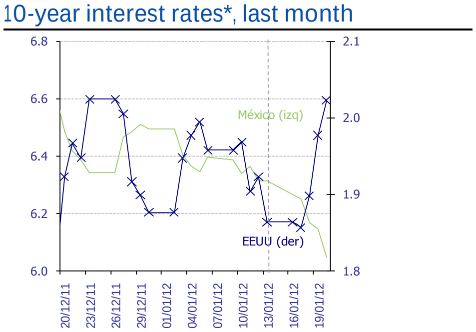
Chart 10
Risk: 5-year CDS (Dec 20, 2011 index=100)



Source: Bloomberg & BBVA Research

Rise in rates in the USA and a fall in Mexico's rates due to greater risk appetite. A neutral tone in Banxico's statement lowers rates at the end of the week.

Chart 11
10-year interest rates*, last month



Source: Bloomberg & BBVA Research

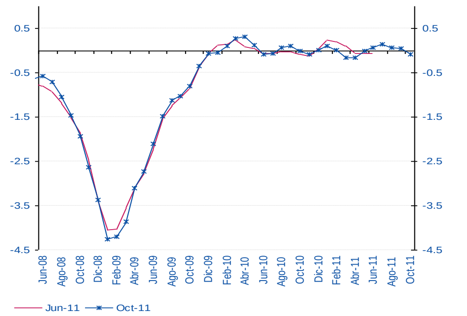
Chart 12
Carry-trade Mexico index (%)

Source: BBVA Research with data from Bloomberg

Activity, inflation, monetary conditions

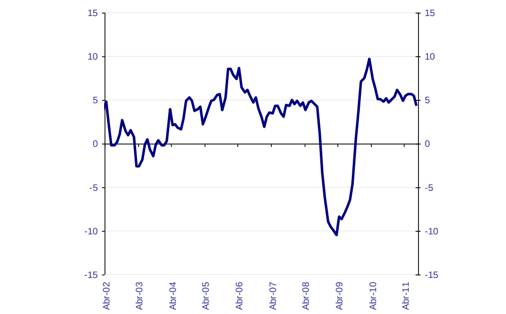
Output holds positive performance, situation indicators point to 3Q11 with quarterly rates around 1%

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.

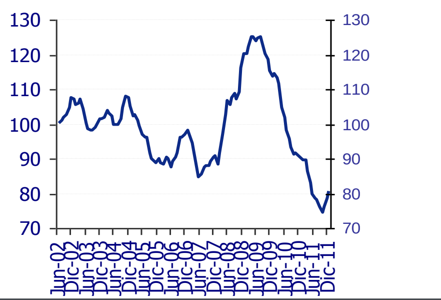
Chart 14
Advance Indicator of Activity (% change y/y)



Source: INEGI

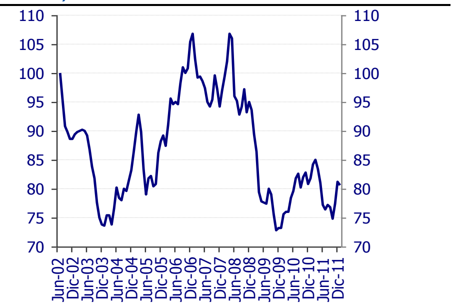
Recent inflationary surprises have been downward, while those concerning economic activity have been mixed.

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.

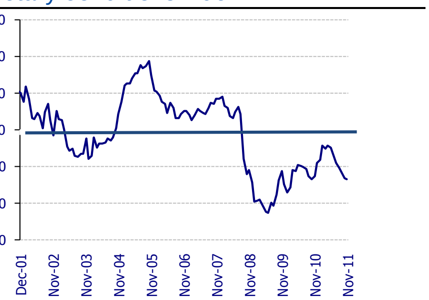
Chart 16
Activity Surprise Index (2002=100)



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.

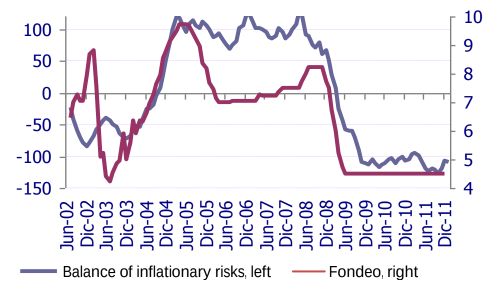
Monetary Conditions relax due to exchange rate depreciation.

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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