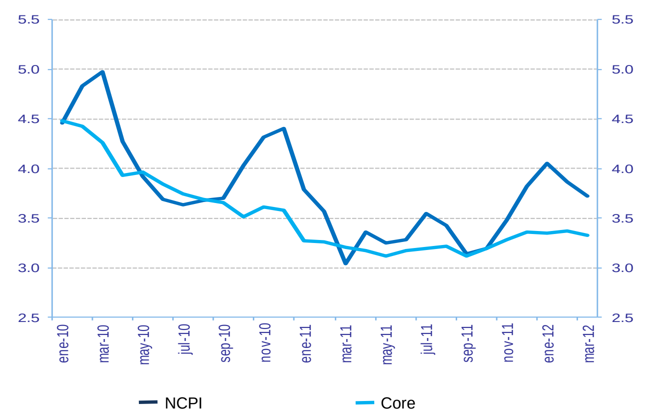
Mexico Weekly Flash

Banxico minutes, downward bias

- **The minutes from the last monetary policy meeting show intense debate surrounding the appropriateness of a lending rate cut which adds to the information in the previous statement. Banxico communicates a downward bias if favorable inflation forecasts strengthen.**
- **For BBVA Research, Banxico doubts on the cost in terms of credibility of a possible policy rate cut supports our pause forecast. The possibility that a deterioration in inflation (currently at 3.7%) follows a rate cut in a growth scenario with rigidity in lower prices could lead to the perception of a lack of commitment in attaining the inflation target.**
  - The minutes from the last monetary policy meeting show a more intense debate that started last July surrounding the appropriateness of a one-day interbank lending rate target cut. There are more open and clearer postures from those members favoring a cut. The debate on the monetary policy rate cut was incorporated moderately by markets.

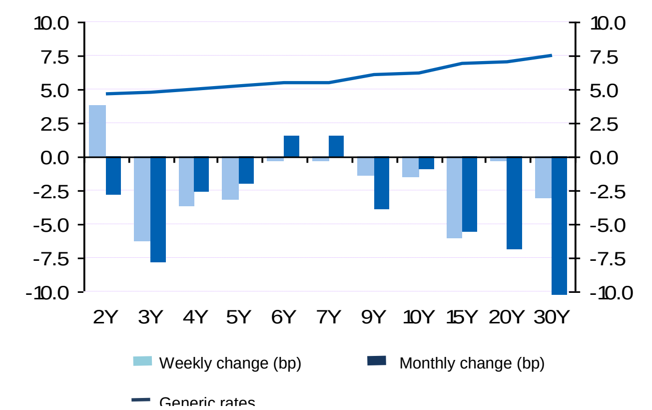
    (cont. on next page)
- **Markets watchful for a cut; we maintain our recommendation to go long M2014 (Dec.) and see relative value in the long section**
  - Given the market could see Banxico's monetary policy decision centering on the possibility of lowering rates, we believe that the short end of the curve will offer more relative short-term value. We repeat our target for the M2014 (Dec.) at 4.75%. We also see more value in the long section compared to the mid-section of the curve in the medium term.

Chart 1
Recorded annual inflation (%)



Source: BBVA Research and INEGI

Chart 2
Mexico: Yield Curve (% generic and bp)



Source: BBVA Research with data from Bloomberg

(continued from previous page) ... The minutes show that most members of the Board signaled that "if current favorable conditions strengthen on inflation forecasts, it may be advisable to make a downward adjustment to the interest rate". A member even stated that the uncertainty surrounding the global scenario had led to postponing this measure. In this sense, BBVA Research stated in October 2011 that a cut to the lending rate was subject to exchange rate performance, affected at that time by global uncertainty. Arguments against the cut are based on the fact that inflation convergence with the long-term target of 3% has not been attained, in addition to medium- and long-term inflation forecasts continuing in the upper section of the variability range of the target. In addition, again a rate cut, given that the inflation target has not been attained, could be interpreted as the Bank of Mexico not committing to attaining the target. This would mean that attaining it in the end would be more costly in comparison to the loss of credibility this could mean.

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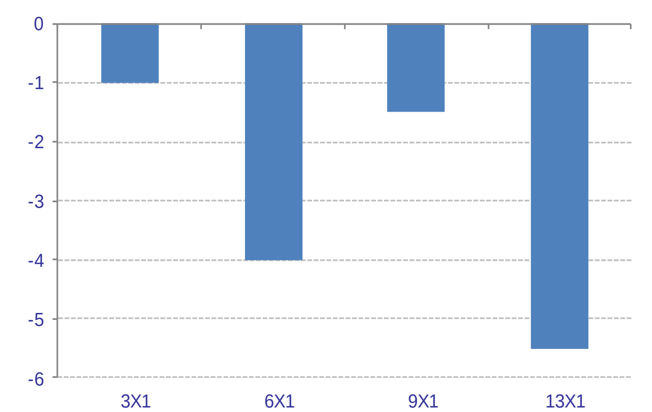
- The last monetary policy decision statement in April did not show changes suggesting the intense debate on the possibility of reducing the target rate. An improvement in the output and inflation risk balances was specifically mentioned. This after inflation came down moderately from 3.94 to 3.72% between the January and March statements. Meanwhile output improved with growth forecasts for this year being 3.3%. This information points, as stated in the BBVA Research Flash from March 16, to a monetary pause forecast.
- According to the Banxico statement, the rate cut would be subject to a strengthening in current favorable conditions for the inflation outlook. Inflation is currently at 3.72% and the BBVA Research outlook puts it at 3.75% at the end of the year. Meanwhile, medium-term inflation forecasts have not consistently hit levels below 3.5%. This outlook linked to expected economic growth of around 3.4% in 2012 point, in our opinion, to the current monetary stance being maintained.

Chart 3

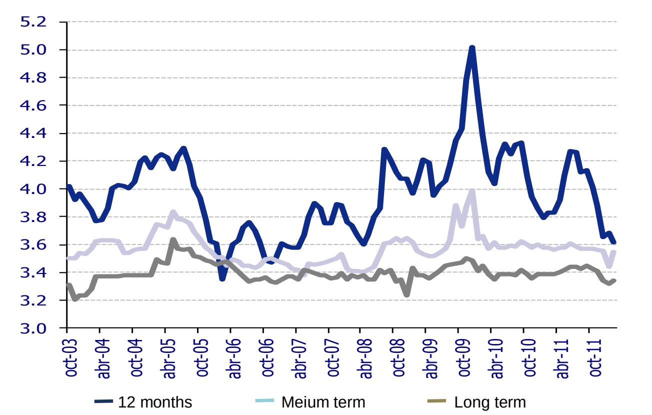
IRS rate change between March 30 and 29 (bp)



Source: BBVA Research with Valmer data

Chart 4

Inflation forecasts (%)



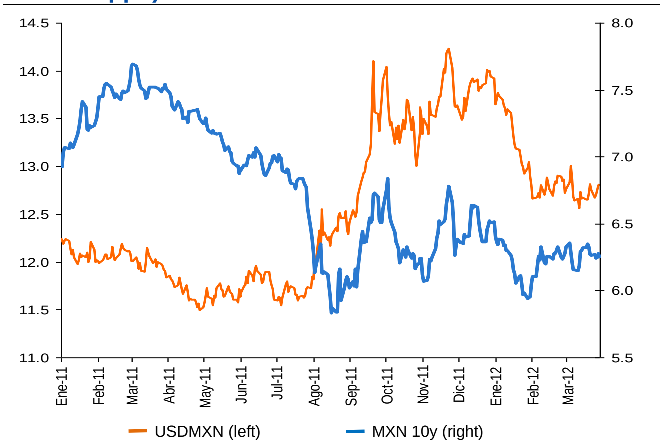
Source: BBVA Research with Infosel data

Markets

- **Markets watchful for a cut; we maintain our recommendation to go long M2014 (Dec.) and see relative value in the long section**

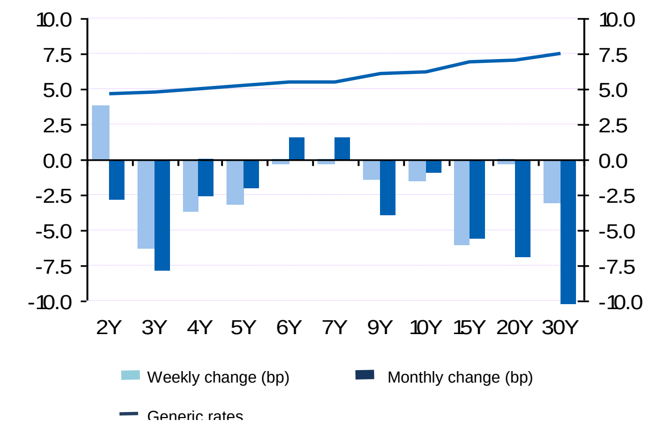
  - Given Banxico's monetary policy decision seems to center on the possibility of lowering rates, we believe that the short end of the curve will offer more relative short-term value. We repeat our target for the M2014 (Dec.) at 4.75% and a stop loss at 5%. Nonetheless, we also see more value in the long section compared to the mid-section in the medium term. It is likely that this strategy will shortly face challenges linked to monetary policy forecasts.
  - The local yield curve continues expensive and without upward determining factors. However, it maintains its attraction due to the soft monetary policy remaining on pause for the time being, growth (albeit sluggish) continues positive and the fiscal balance remains healthy. A slightly more positive growth outlook from Banxico, albeit with an output gap far from being closed alongside lower inflation risks, not only point to a prolonged monetary policy pause but also to a margin to go long in the long section of the curve.
  - We continue to believe that the mid-section of the curve still has to hit lower relative values. We therefore confirm our long M30Y/short M7Y position with a target at 165bp and stop loss at 208bp.

Chart 5
10-year bond in Mexico and the MXN (annual %, fixed rate and ppd)



Source: BBVA Research with data from Bloomberg

Chart 6
Mexico: Yield Curve (% generic and bp)



Source: BBVA Research with data from Bloomberg

Technical Analysis

IPC Stock Market Index

Source: BBVA, Bancomer, Bloomberg

An upward break week on the IPC stock market. After accumulating a month and half in the 900pts range, it finally hits the resistance break and records new historical maximums. With a new floor at 38,700pts, we believe it could extend the move toward the 40,000pts psychological level. Amx may continue to support the market's upward move having broken MXN16.00. An upward break of MXN16.15 would set the next target toward MXN16.50.

Previous Rec.: We believe an upward break is still likely setting a target of 39,300pts, a result of projecting up the 900pts from the lateral range

MXN

Source: BBVA, Bancomer, Bloomberg

New bounce from MXN12.60, still in the trading range from recent months. Set to find resistance in the MXN12.90/13.00 range and we still see no trend change above this ceiling level.

Previous Rec.: At this point, we recommend taking short positions awaiting a return to MXN12.60. Only an upward break of MXN13.00 would provide a short-term buy

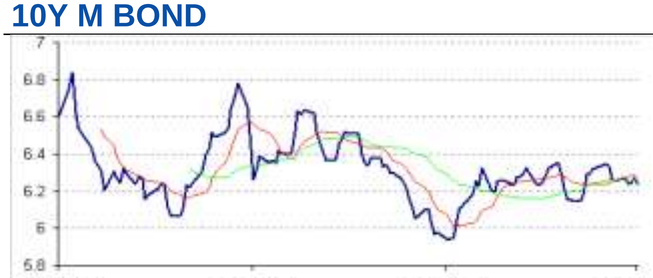
3Y M BOND

Source: BBVA, Bancomer, Bloomberg

3-YEAR M BOND: (yield): Return over the week for the bond again coming in below the 200-day rolling average. It is important it respect the 4.84% zone since, if not, it would search out 4.7%.

Previous Rec.: This sets the next upward target at 5% by hitting through the 200-day rolling average

10Y M BOND



Source: BBVA, Bancomer, Bloomberg

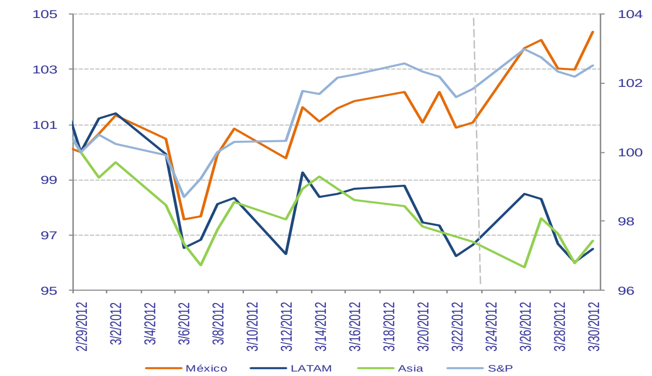
10-YEAR M BOND: (yield): Unable to hit entry as it failed to break the 200-day rolling average. We would only see a buy signal with an upward break of 6.41% or a return to the 6.1% floor.

Previous Rec.: Still failing to produce an entry signal as still trading below the 200-day rolling average (6.41%).

Markets

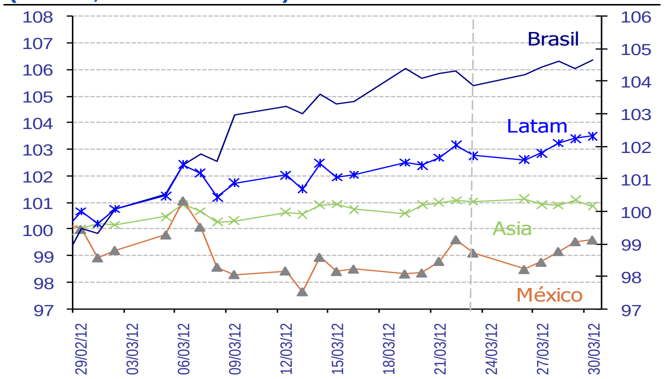
- **Stock markets see gains over the week after the FED chair stated that a new round of monetary stimulus has not been ruled out, as well as releasing better-than-expected data on spending and consumer confidence in the US. The exchange rate fell moderately over the week.**

Chart 7
Stock Markets: MSCI Indices (Feb 29, 2012 index=100)



Source: Bloomberg & BBVA Research

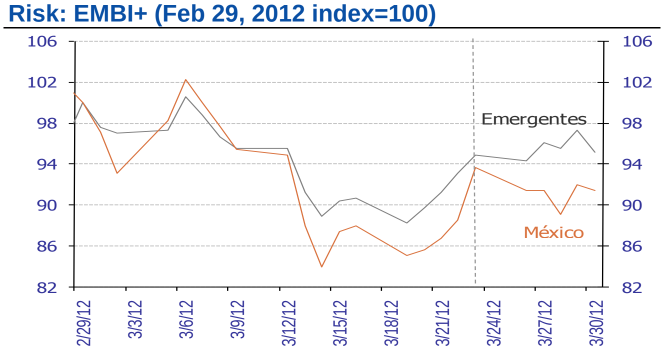
Chart 8
Foreign exchange: dollar exchange rates (Feb 29, 2012 index=100)



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

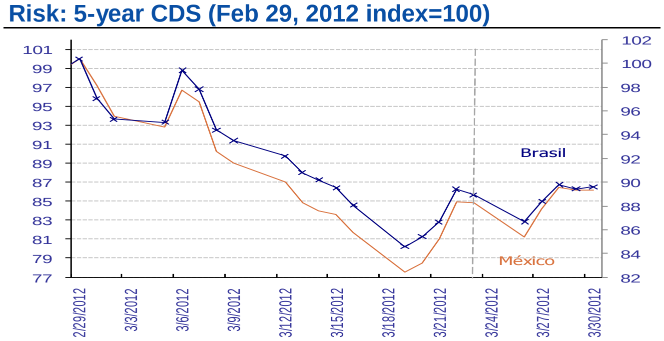
- **Risk aversion indicators see marginal change over the week**

Chart 9
Risk: EMBI+ (Feb 29, 2012 index=100)



Source: Bloomberg & BBVA Research

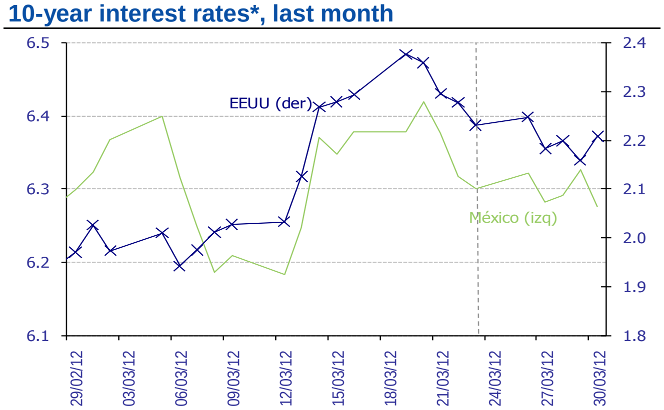
Chart 10
Risk: 5-year CDS (Feb 29, 2012 index=100)



Source: Bloomberg & BBVA Research

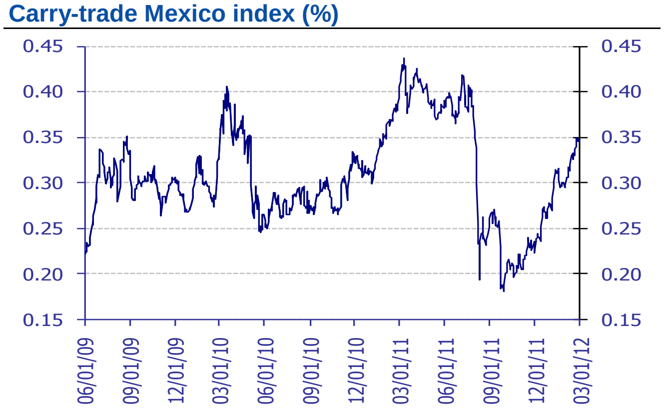
- **Fall in U.S. interest rates after FED chairman statements. Rates in Mexico maintain a positive correlation with US Treasury rates over the week.**

Chart 11
10-year interest rates*, last month



Source: Bloomberg & BBVA Research

Chart 12
Carry-trade Mexico index (%)

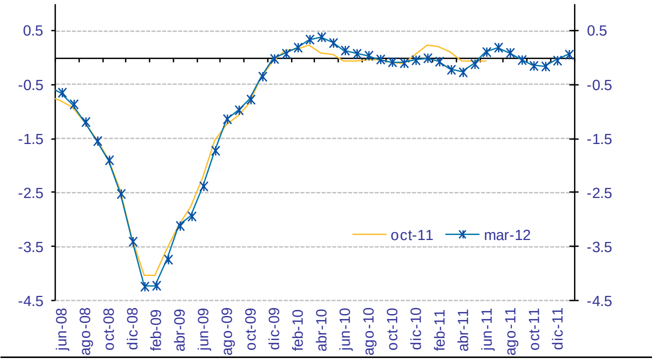


Source: BBVA Research with data from Bloomberg

Activity, inflation, monetary conditions

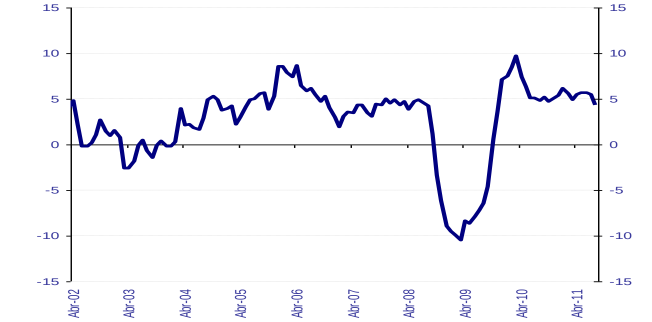
- **Output holds positive performance, situation indicators point to 1Q12 with quarterly rates around 0.6%.**

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.

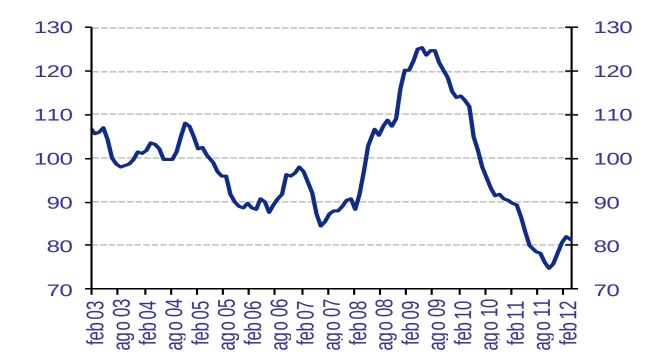
Chart 14
Advance Indicator of Activity (% change y/y)



Source: INEGI

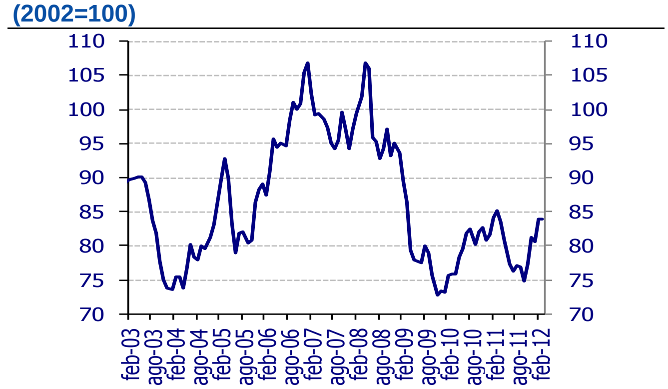
- **The last inflation surprise was downward while, in general, activity continues to offer positive surprises.**

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.

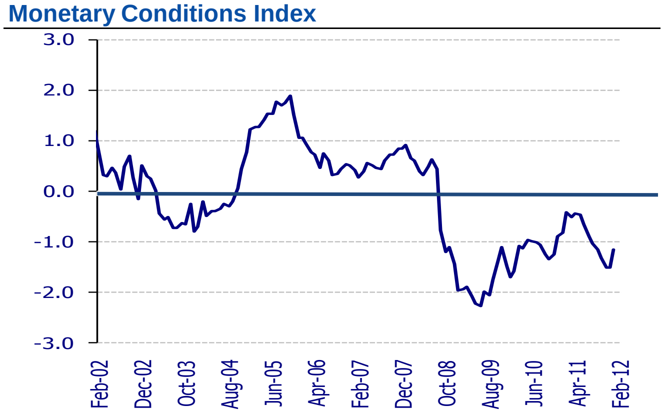
Chart 16
Activity Surprise Index (2002=100)



Source: BBVA Research with data from Bloomberg. Difference between recorded data and the Bloomberg consensus for seven activity variables in Mexico. Standardized index. Rises (falls): positive (negative) surprises.

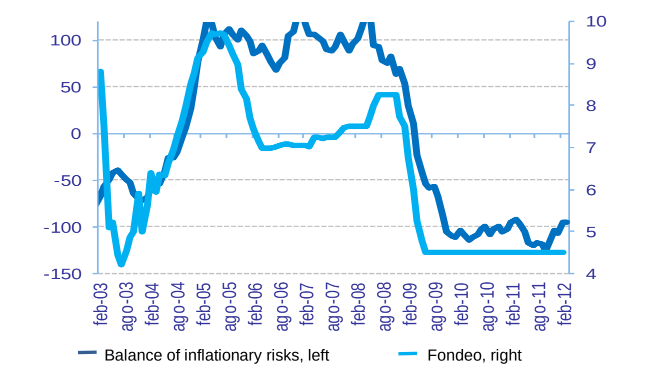
- **Monetary conditions slightly strained due to recent exchange rate appreciation.**

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 and weighted index (of inflation and economic growth) based on economic indicators of economic activity and inflation. A rise in the index points to a greater weight of inflationary risks over growth risks and thus a greater possibility of monetary restriction

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