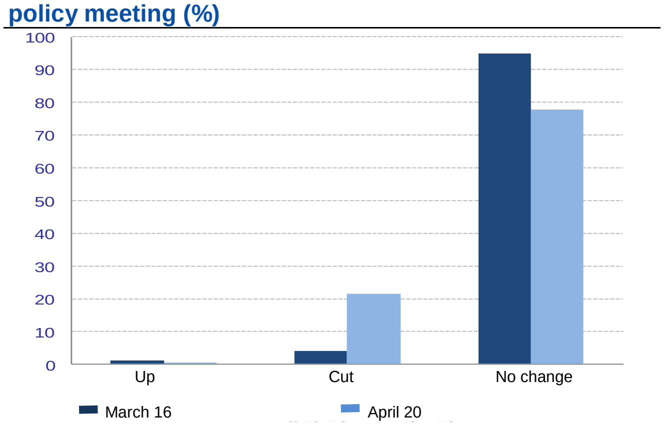
Mexico Weekly Flash

Next week…

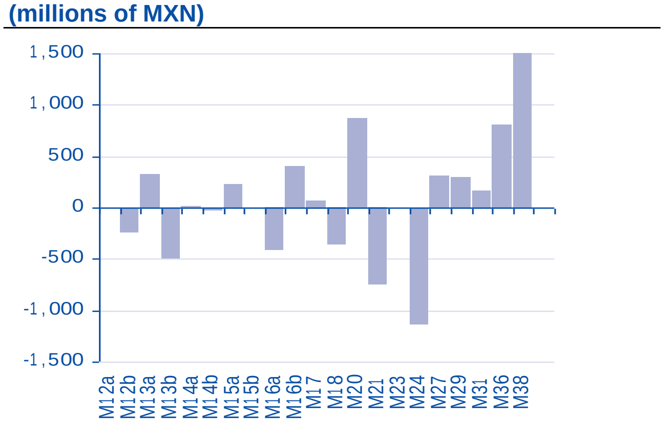
- **... all eyes on Banxico. We maintain our forecast for the Lending Rate to continue at 4.5% although a major decline in inflation in the first two weeks of April would increase likelihood of a cut.**
  - The more accommodating tone in the last minutes and later lower-than-expected inflation figure for March led to a change in market expectations which points to a monetary policy rate cut on Friday April 20.
  - We believe Banxico will keep the lending rate at 4.5% for the following reasons. Firstly, we believe inflation will continue in the higher range of the central bank's target band (3% +/-1pp) for the rest of the year and may even hit 4% over the summer. Secondly, in recent years the Mexican economy has seen a stable performance thanks to implementing orthodox public policies. Nonetheless, it cannot be said that the price formation process has changed enough for inflation to hit the 3% level in coming months (the price stability target) consistently. Thirdly, there is no consensus on the Banxico board regarding possible effects in terms of credibility of a rate cut in a scenario where inflation is in the higher band of the target range. Medium-term inflation forecasts are above the 3% target, specifically at 3.5%, and yearly growth is expected to be around 3.5% (the mid-point on the Banxico forecast range). Inflation continues to be exposed to both internal and external risks appearing, some of which led to rises in different months in 2009 and 2010.
  - However, a major decline in inflation in the first two weeks of April, as well as lower economic growth outlook or a stronger monetary easing tone in next week's statement from the US Fed, would support the position of members who propose a lower lending rate. This would increase the likelihood of a cut.
- **MXN strengthening and gains in long sections of the curve**
  - Greater MXN sensitivity to news on cyclical, sovereign risks and speculation on monetary bias in US and Mexico remains. In turn, the MBond and TIIE curve saw gains over the week, with higher demand in the long section from foreign investors.

Chart 1
Likelihood of seeing a rate move at the next monetary policy meeting (%)



Source: ThomsonReuters

Chart 2
Mexico: Net Weekly Foreign Inflows to MBOND curve (millions of MXN)



Source: BBVA Research, Banxico, Indeval

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Calendar: Indicators

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

Forecast: -0.08% bi-weekly 3.75% y/y	Consensus: N.A.	Previous: 0.05% m/m 3.73% y/y March

On Tuesday, inflation figures for the first two weeks of April will be released. We forecast a figure of -0.08% bi-weekly due to a seasonal fall in electricity prices for the warm season. Inflation will remain stable in annual terms: 3.75% vs. 3.73% for March. Core inflation will have increased 0.03% bi-weekly with some upward pressures due to seasonal increases in tourist services. These will reverse in the second fortnight of the month. Core inflation will remain highly stable in annual terms: (3.35%). Inflation has recorded downward surprises in recent weeks but these were due to more volatile prices such as agricultural prices. This means that if factors such as a major fall in the peso or a new increase in grain prices around the world, inflation could see a bounce. This is why we believe that the inflationary risk balance is balanced after a good price performance in the first quarter.

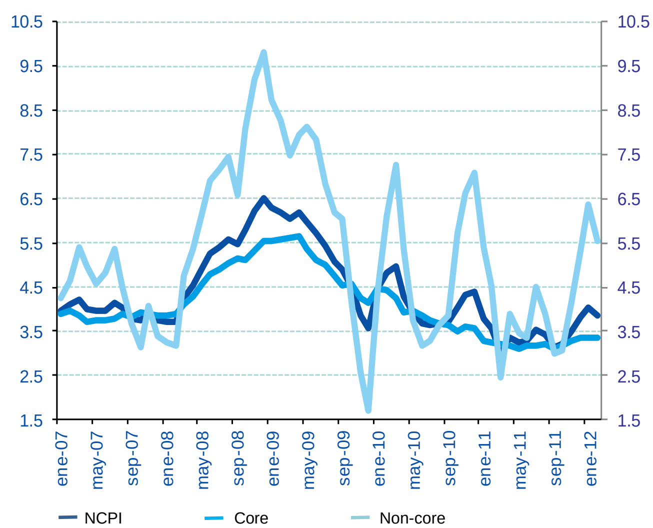
Retail Sales and IGAE for February (Monday 23 and Wednesday 25 April)

Forecast: Sales 0.0% m/m 3.7% y/y	Consensus: N.A.	Previous: 0.9% m/m 4.5% y/y
Forecast: IGAE -1.4% m/m 2.1% y/y	Consensus: N.A.	Previous: 0.5% m/m 3.8% y/y

This will be an important week due to the release of output indicators providing information on the strength of domestic demand. Monday sees the release of retail sales for February. We expect to see a negative effect due to the leap year. This would mean, as we saw with industrial output, an adjustment that may be important in monthly terms. Nevertheless, we believe that beyond how "bizarre" February's figures may seem, the relevant variables for sales indicator performance such as employment and real salaries continued to show strength in the second month of the year. On the one hand, employment (private formal) which in the month in question included 0.5% additional workers over January, as well as real salary growth, will help in the expected adjustment for February not coming in extremely high. On the other, consumer confidence has been stable with a slightly negative change over the previous month in February and March (-0.1% respectively) without leading to a major adjustment.

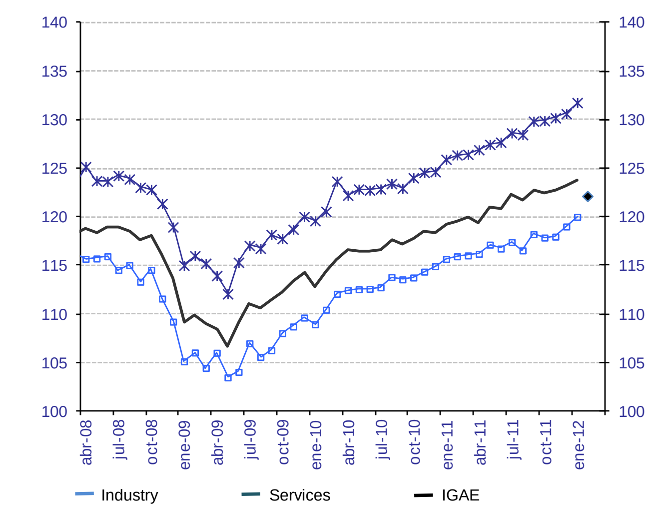
In turn, the IGAE to be released on Tuesday 24 and with the already released industrial output (-1.7% m/m) will provide important information on how services performed. We also believe that despite the adjustment possibly being important, this does not point to a trend change but merely a temporary effect in output.

Chart 3
Inflation breakdown (% change y/y)



Source: BBVA Research with INEGI data

Chart 4
IGAE 2003 Index=100



Source: BBVA Research with Banxico data

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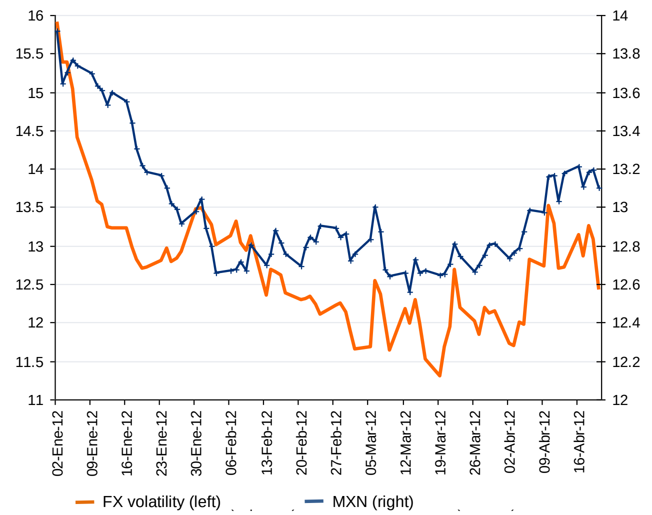
Markets

- **Despite high volatility, the MXN ended the week higher by 0.7%**
  - After seeing high volatility over most of the week, the MXN closed on Friday with a strengthening of 0.7%. It again hit the edges among EM and G10 currencies, this time seeing the best relative performance. This is not surprising since it remains highly sensitive to any type of news regarding the cyclical and sovereign risks and, right now, regarding changes in expectations for monetary stances at Banxico and the Fed.
  - We could see a consolidated return to the lower end of the range over the week if a relatively favorable result from the G10 aligns with the continued recent tones from monetary authorities. In all, negative output surprises persist, limiting any positive bias in the short-term.

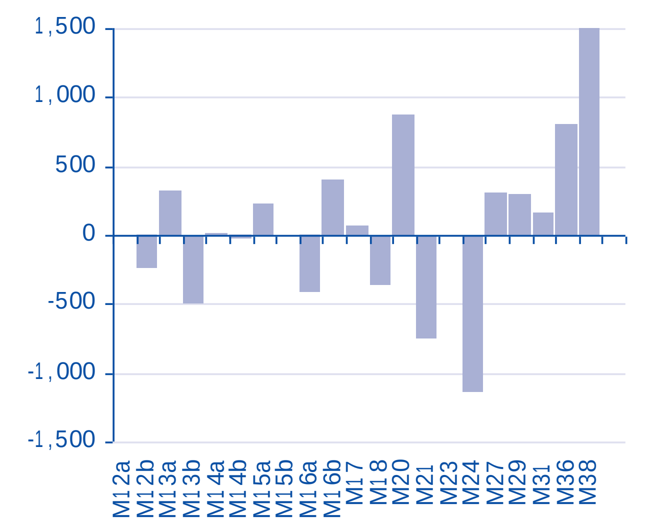
- **The MBond and TIIE curve saw gains over the week**
  - The long maturities saw greater activity, i.e. curves lost some slope excess. In this sense, we saw higher demand in the long section from foreign investors. In fact, the SHCP auctioned the syndicated 30-year Bond over the week (the first syndicated at this maturity) with high foreign investor participation. Syndicated MBonds issued previously were for a maturity of 5, 10 and 20 years.

Chart 5
Mexico: MXN/USD and implied 1-month volatility (ppd and %)



Source: BBVA Research and Bloomberg

Chart 6
Mexico: Net Weekly Foreign Inflows to MBOND curve (millions of MXN)



Source: BBVA Research, Banxico, Indeval

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Technical Analysis

IPC Stock Market Index

Source: BBVA, Bancomer, Bloomberg

Positive week on the IPC although we think the move may be limited to 40,000pts. As short-term oscillating indicators never hit over-sell zones, a return to 40,000pts would place them again at very high over-buy readings and make an upward break difficult. In order to be in a short-term buy scenario, we recommend waiting for one of these events: a return to 38,000pts or an upward break through 40,000pts.

Previous Rec.: We believe this move may extend toward the 38,000pts zone.

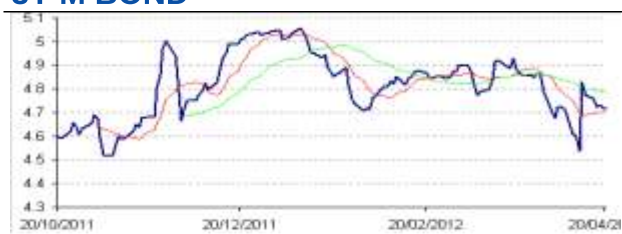
MXN

Source: BBVA, Bancomer, Bloomberg

Dollar remained in the MXN13.00 and MXN13.20 trading range over the week. We believe this lateral move may be the start of a move toward the MXN13.40 or even MXN13.50 range. This will remain valid while it stays above MXN13.00.

Previous Rec.: The upward break through the higher range sends out a major upward signal with an initial target at MXN13.40. This is due to an upward projection in the lateral range of 40 centavos.

3Y M BOND

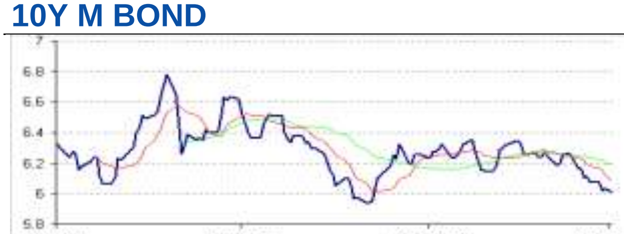


Source: BBVA, Bancomer, Bloomberg

3-YEAR M BOND: (yield): Fails to maintain bounce from last week and adjusts toward the 10-day rolling average. The opening between this level and the 30-day rolling average makes us consider a bounce toward 4.9% with stop loss below 4.7%.

Previous Rec.: It may extend the move toward the next resistance at 4.95%.

10Y M BOND



Source: BBVA, Bancomer, Bloomberg

10-YEAR M BOND: (yield): Remains low and hits the 6% zone. We believe at this level it could bounce with an initial target at 6.2%. It is already trading near the yearly low.

Previous Rec.: It maintains its downward trend that may extend toward the 6% zone.

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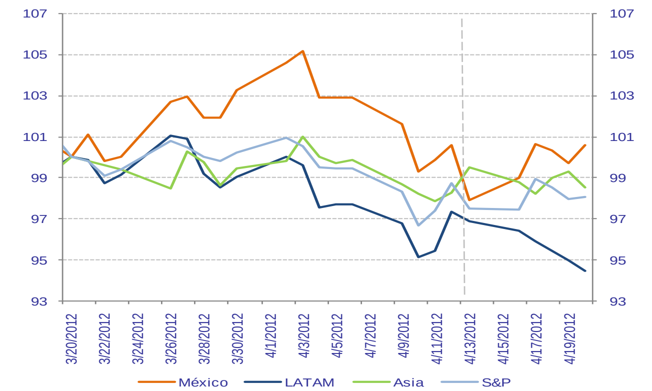
Markets

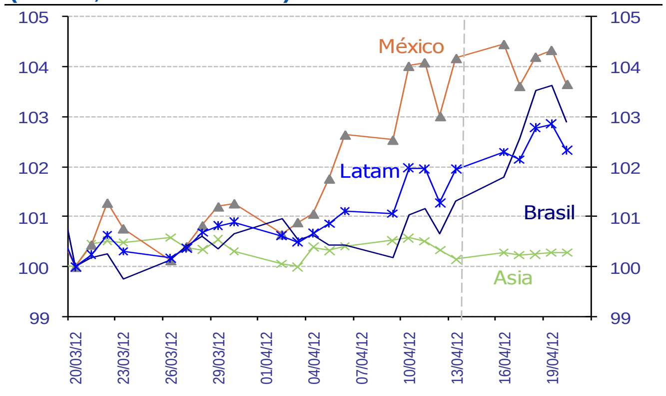
- **Stock markets marginally up over the week after the increase in world growth forecasts at the IMF. The peso strengthened toward the end of the week due to better-than-expected business confidence data from Germany and better corporate reports on Wall Street.**

Chart 7
Stock Markets: MSCI Indices (Mar 20, 2012 index=100)



Source: Bloomberg & BBVA Research

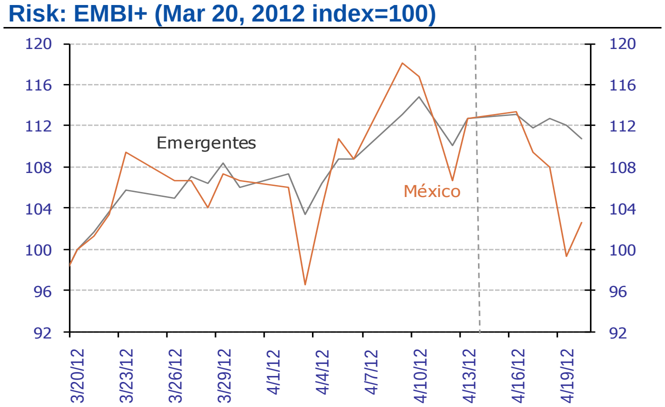
Chart 8
Foreign exchange: dollar exchange rates (Mar 20, 2012 index=100)



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

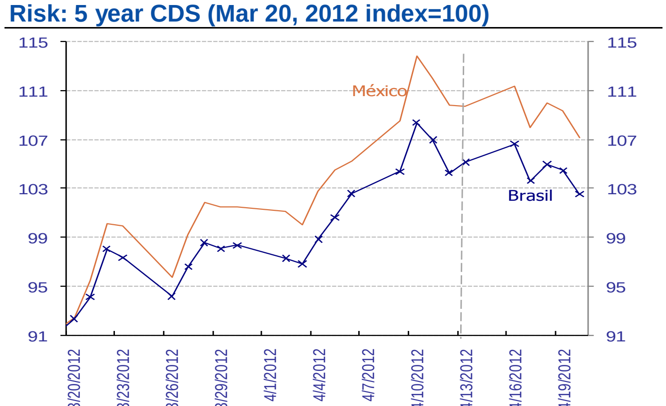
- **Increase in risk aversion mid-week influenced by the higher non-performing loan portfolio at Spanish banks**

Chart 9
Risk: EMBI+ (Mar 20, 2012 index=100)



Source: Bloomberg & BBVA Research

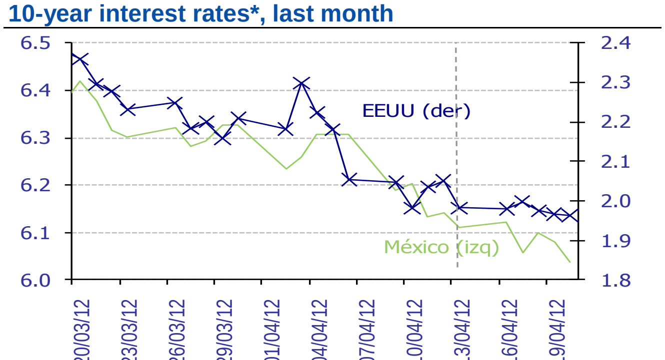
Chart 10
Risk: 5 year CDS (Mar 20, 2012 index=100)



Source: Bloomberg & BBVA Research

- **Slight fall in US and Mexican rates. Domestic rates continue to discount a cut in the lending rate this coming Friday, April 27**

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

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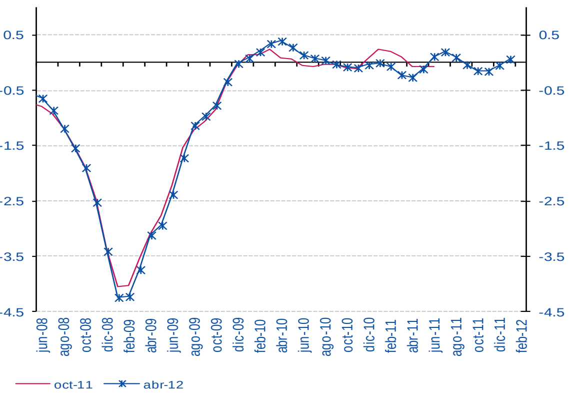
Activity, inflation, monetary conditions

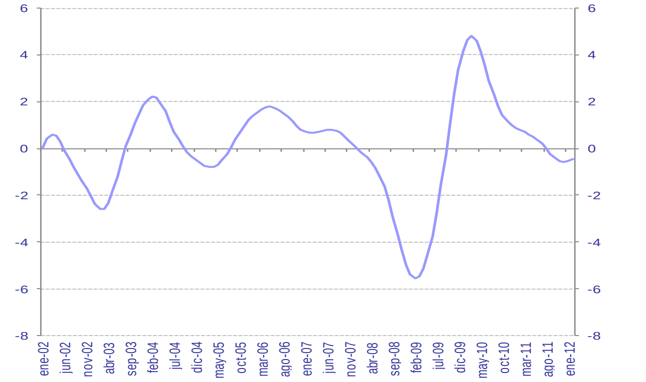
- **Output holds positive performance, situation indicators point to 1Q12 with quarterly rates around 0.5%.**

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.

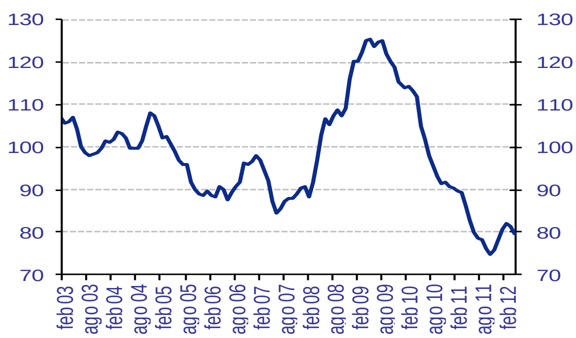
Chart 14
Advance Indicator of Activity (% change y/y)



Source: INEGI

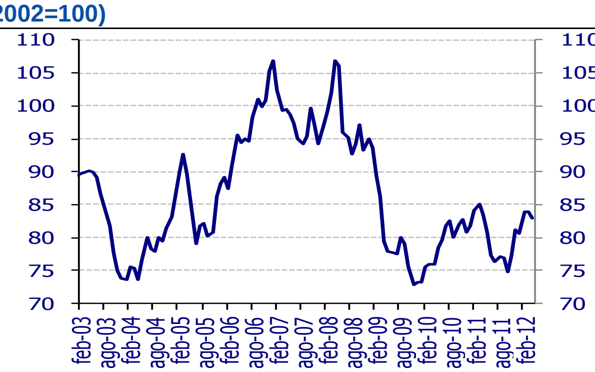
- **The last inflation surprise was downward while, in general, activity continues to offer positive surprises.**

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.

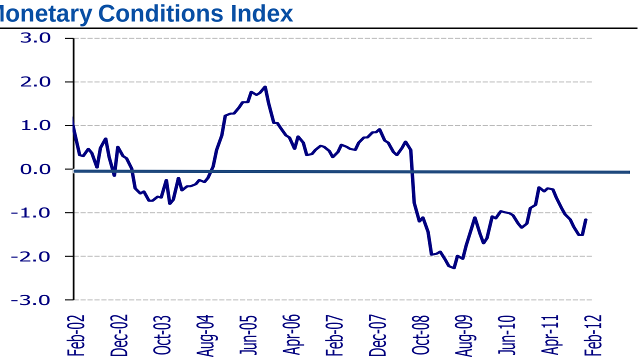
Chart 16
Activity Surprise Index (2002=100)



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.

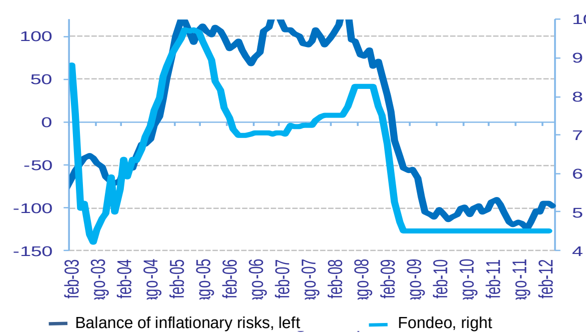
- **Monetary conditions slightly strained due to recent exchange rate appreciation.**

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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