Mexico Weekly Flash

Next week…

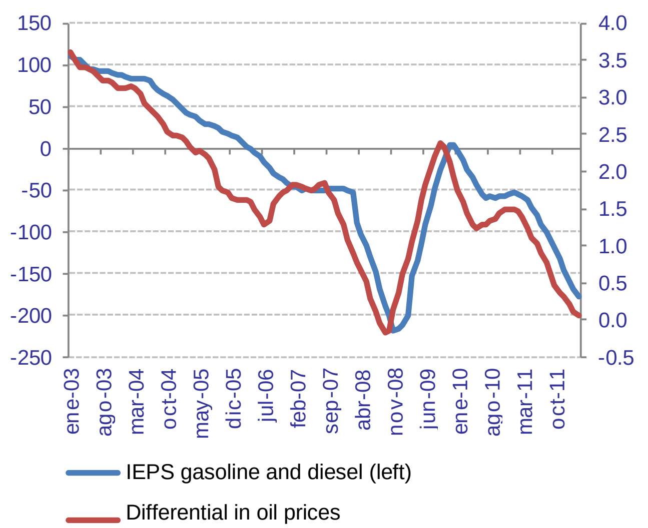
- ### Public Finances: IEPS and Gasoline Performance

Next week sees the release of Public Finance statistics for April, an important indicators not only as an advance on compliance with the approved budgeted deficit for the year (-2.4% of GDP), tax performance and public spending but also to discover the fuel subsidy amounts, i.e. IEPS (Special Tax on Products and Services) collection from gasoline and diesel. When the average public sales price for gasoline and diesel comes in below the Pemex production price, there is a negative flow in oil revenue, i.e. a subsidy and when it comes in above, there is a positive flow, i.e. a tax. A good exercise to see where the Pemex production price is likely to sit comes from comparing the price difference for oil (Magna) in Mexico and oil in the US (Gulf Coast 87 octane) in pesos (see Chart 1), since when the difference closes between the two, the subsidy increases, i.e. the IEPS flow is more negative. For the 2012 tax year, Congress approved a fuel subsidy of 26.181 bn pesos (0.17% of GDP); however, due to increases in oil prices and derivatives on international markets, up to March there had been a subsidy of around 50.687, around 0.33% of estimated GDP for 2012 and 193.6% of the approved amount.

Although we believe this deviation will continue to increase and hit between 1% and 1.25% of GDP for the year, this will not lead to any deviation from the approved fiscal deficit target. This should not avoid the implications of fuel subsidies on the efficiency in consuming a scant resource such as oil.

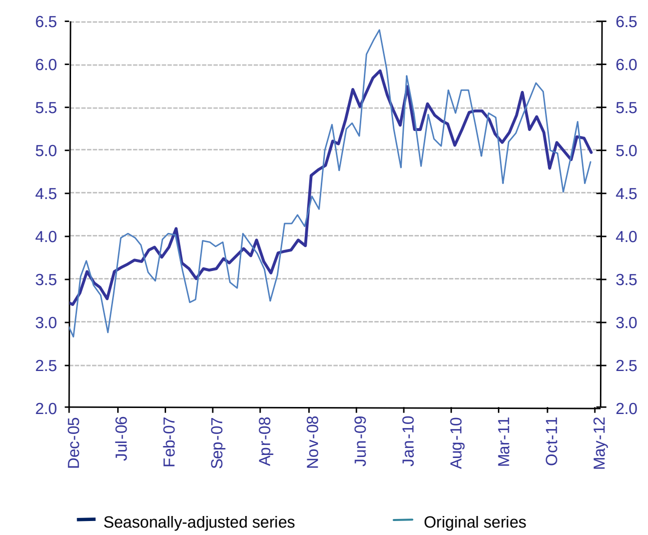
This last week saw figures released on retail sales and the jobless rate confirming stability in domestic demand indicators in the first months of the year, although there continues to be downward resistance on the unemployment rate and underemployment figures.

Chart 1
IEPS Gasoline and Diesel (millions of pesos, 12-month rolling average) and differential between the oil price in Mexico and the US (pesos, 12-month rolling average)



Source: BBVA Research with data from Bloomberg and SHCP

Chart 3
Unemployment rate (original series and seasonally-adjusted series, % of EAP)



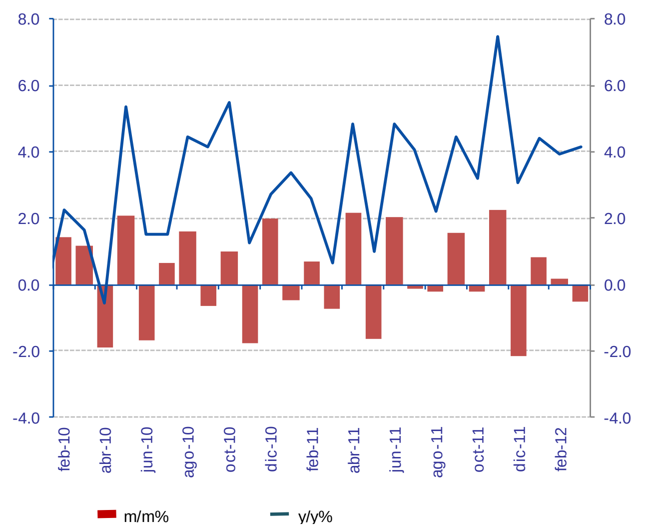
Calendar: Indicators

There are no major indicators this week

In the first instance, retail sales increased 4.1% y/y in March meaning growth in the first quarter at retail establishments came in at 4.2%, slightly below the 4.6% seen in 4Q11. In turn, the seasonally-adjusted jobless rate for April was 5%, with high stability over the last twelve months. Further, the underemployment rate remains stable at around 8.2% of those in work.

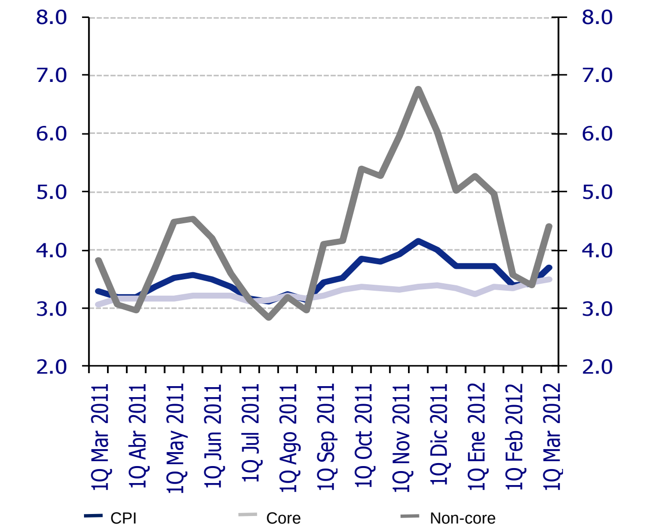
May inflation figures were releases which fell 0.48% in the first two weeks of May. However, it moved up in annual terms for 3.71%. We believe that inflation fundamentals continue to be in line with a year-end figure below 4%. Nevertheless, given the different external shocks affecting the peso, if there are upward surprises in coming months in non-core price components, the chance of inflation temporarily coming in above this threshold in some month of the third quarter of the year cannon be ruled out.

Chart 3
Retail Sales (% y/y and m/m)



Source: BBVA Research with INEGI data

Chart 4
Headline inflation and Components (% change y/y)



Global risk aversion continues with the MXN in tune with Europe

Local assets again came under pressure over the week. The MXN started a positive bias due to expectations surrounding the information EMU leaders meeting. However, as the days passed, the lack of news that may have moderated uncertainty on Greece's future gained more weight. In addition to this was the series of downward surprises in economic indicators from China to the US. This led to a continued decline in risk assets. In this way, the MXN ended the week 1.4% lower after having hit highs near 14.06 over previous days. In fact, the currency market intervention conditions for Banxico were activated for the first time since the mechanism was announced in November 2011, i.e. psychological intraday resistance of 2% above the previous fix stopped be the depreciation limit reference for investors. We believe this negative sentiment will continue to be the trend in coming days.

The currency's performance was also reflected in domestic fixed-income instruments, albeit in lower proportion. The MBond curve moved up in the weekly balance, a move more noticeable in the longer maturities even when part of the steepening from previous days was corrected latterly (the 30-year yield went up 7bp). In all, the absence of clarity on the market remains: there are no trends just high volatility movements. In addition, foreigners continued holding maturity adjustments in the curve more so than an exit into safe-haven assets. As we have stated, we expect this performance to remain, we especially believe the defensive posturing will continue.

Technical Analysis

IPC

After a fall of just over 3,000pts, the IPC has started a slight upward move above the important technical floor set by the 200-day rolling average. The pattern on the daily chart suggests that the upturn may be maintained. The opening between the 10- and 30-day rolling averages of over 1,000pts means the market may still hit the 38,000 to 38,300pts range. Now, given the supports broken during the downward move, we could consider the market is trading in a short-term downward trend and this bounce may only be a temporary reaction within this negative movement. In order to consider a short-term upward move, the IPC has to return trading above its 30-day rolling average (38,700pts).

Previous Rec.: Due to the high over-sell readings in IPC issuers, we believe the market will respect the new support level

Source: BBVA, Bancomer, Bloomberg

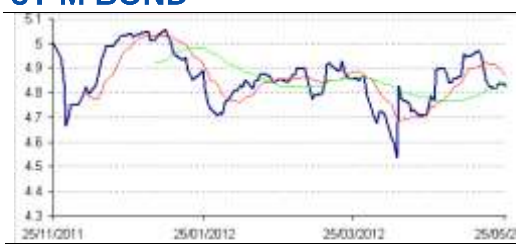
MXN

The dollar ended the week in the MXN14.00 zone, increasing overbuying readings already present from the previous week. Although an over-reaction to MXN14.30 (last year's high) cannot be ruled out, we insist that current dollar levels are very high and represent a sell range.

Previous Rec.: The over-purchasing in oscillating indicators does not suggest that it should return to MXN13.20 zone in the next few sessions.

Source: BBVA, Bancomer, Bloomberg

3Y M BOND

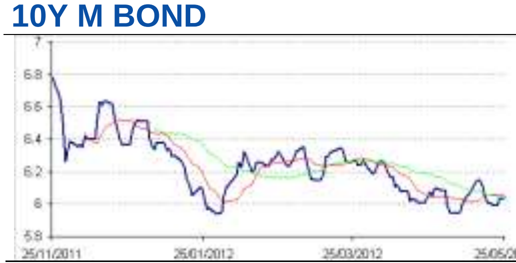


3Y MBOND: (yield): A return to the floor range where 10-, 30- and 200-day rolling averages sit. We see a zone where a bounce may begin and would only consider an exit if it breaks down through 4.79%.

Previous Rec.: This backward move could find a floor in the 4.78% zone where several short-term rolling averages sit, as well as the 200-day rolling average.

Source: BBVA, Bancomer, Bloomberg

10Y M BOND



10Y MBOND (yield): A return to the 6% support and we believe it may re-start the upward move toward 6.2%.

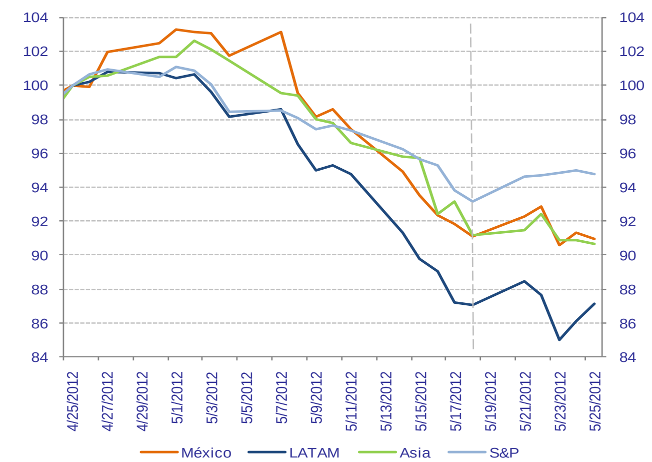
Previous Rec.: It may return to the 6% zone.

Source: BBVA, Bancomer, Bloomberg

Markets

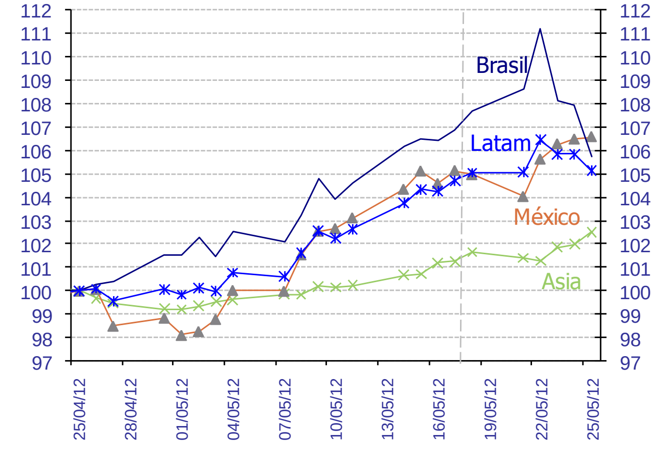
- **The lack of agreement among European leaders on a solution to the European debt crisis, as well as concerns surrounding the Spanish banking sector lead to falls on stock markets and a lower peso. The BRL appreciated after the Brazilian Central Bank auctioned currency swaps for the fourth day in a row.**

Chart 7
Stock Markets: MSCI Indices (Apr 25, 2012 index = 100)



Source: Bloomberg & BBVA Research

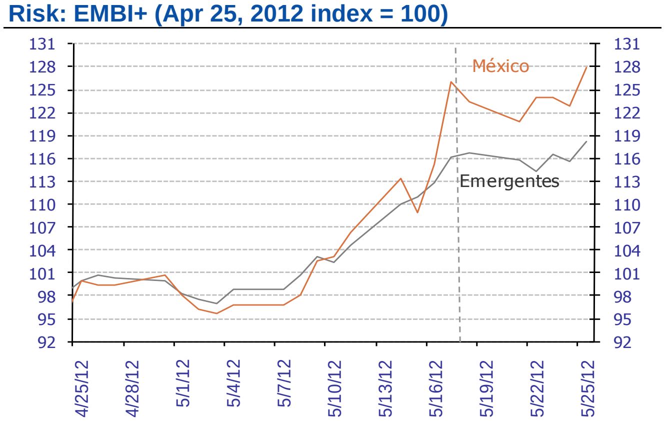
Chart 8
Foreign exchange: dollar exchange rates (Apr 25, 2012 index = 100)



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

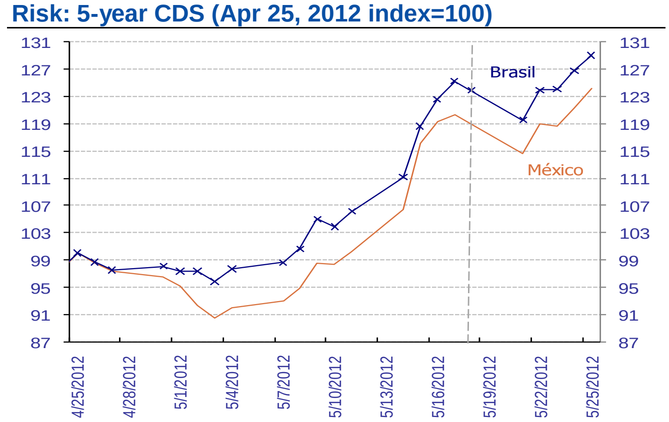
- **Increased risk aversion aggravated by rumors surrounding European leaders preparing measures in case Greece exits the euro.**

Chart 9
Risk: EMBI+ (Apr 25, 2012 index = 100)



Source: Bloomberg & BBVA Research

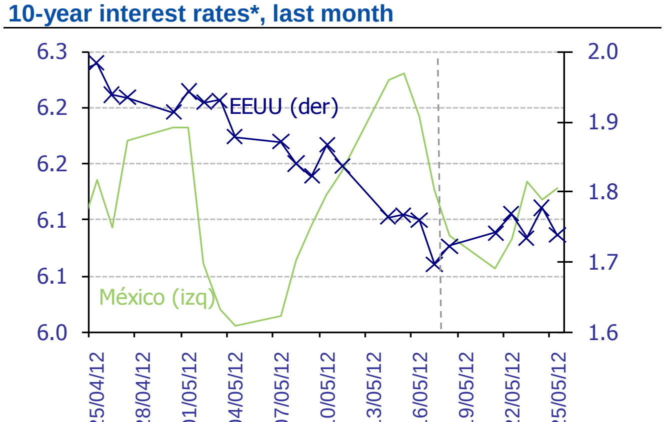
Chart 10
Risk: 5-year CDS (Apr 25, 2012 index=100)



Source: Bloomberg & BBVA Research

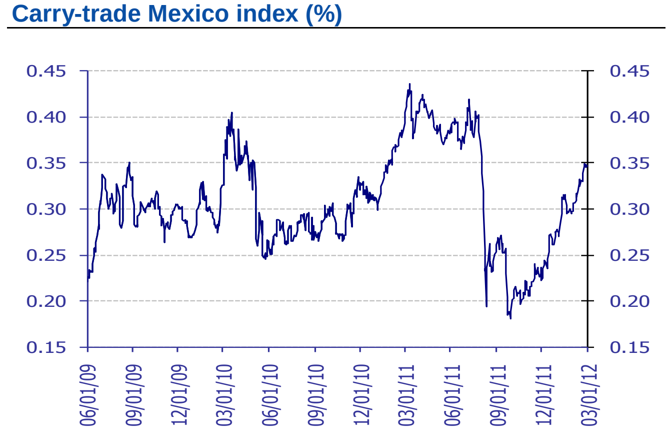
- **Interest rates increase due to greater global risk aversion.**

Chart 11
10-year interest rates*, last month



Source: Bloomberg & BBVA Research

Chart 12
Carry-trade Mexico index (%)

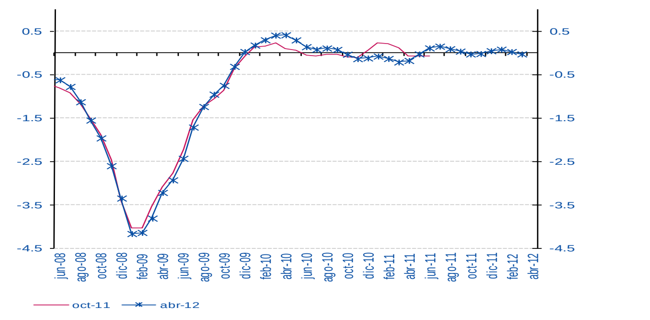


Source: BBVA Research with data from Bloomberg

Activity, inflation, monetary conditions

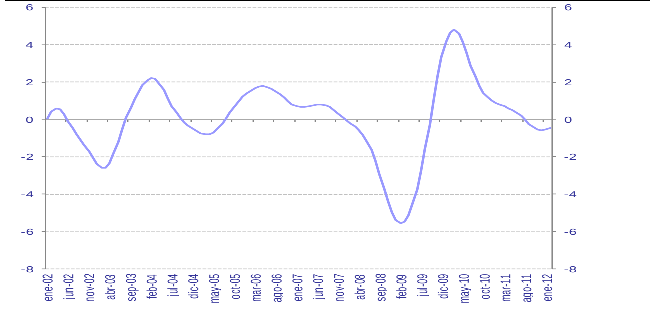
- **Output holds positive performance, situation indicators point to 1Q12 with quarterly rates around 0.5%.**

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.

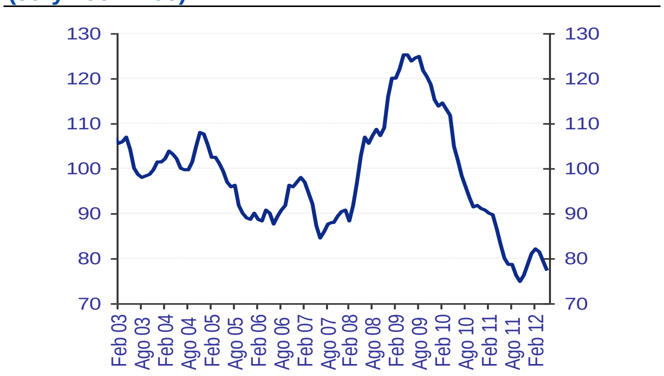
Chart 14
Advance Indicator of Activity (% change y/y)



Source: INEGI

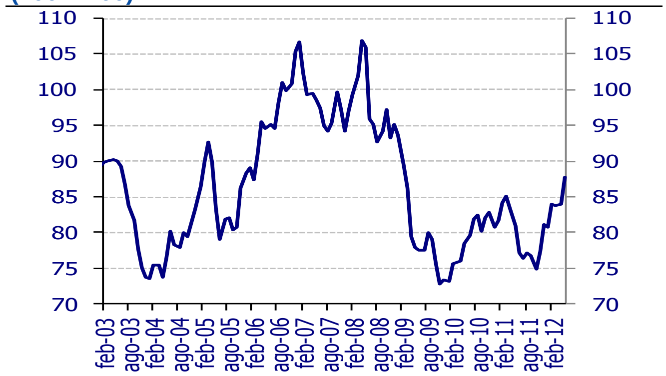
- **Both the recent inflation and output surprises were downward.**

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.

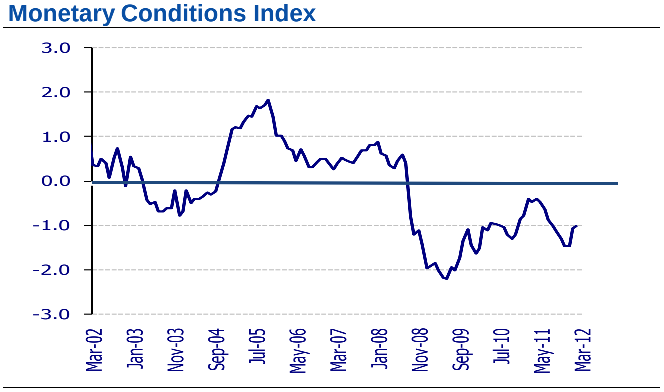
Chart 16
Activity Surprise Index (2002=100)



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.

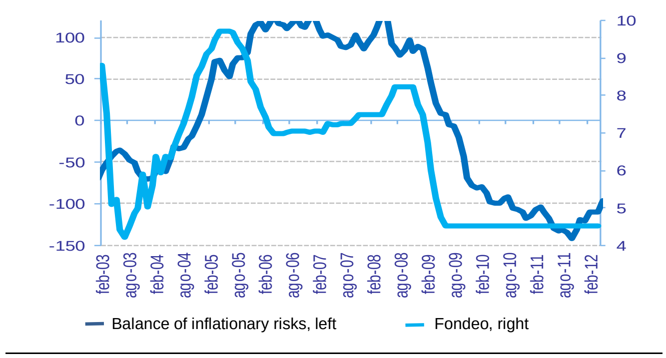
- **Monetary conditions near neutral zone**

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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