Mexico Weekly Flash

Next week…

- ### Banxico set to keep monetary policy target rate

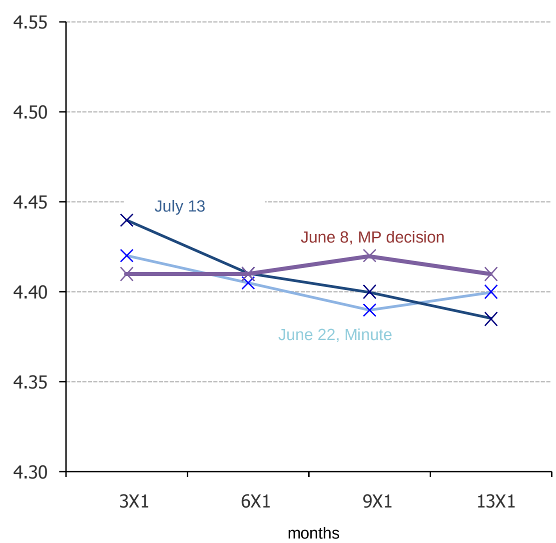
Friday next week, July 20, sees Banxico release its monetary policy decision. The latest data on economic activity and inflation, alongside the recent central bank statement, are in line with maintaining the monetary pause. In terms of output, although growth forecasts for this year remain above 3.5%, uncertainty around the external scenario and signs of a domestic slowdown continue. This is true for industrial output in May which saw a larger-than-expected decline (-0.9% vs. -0.2% m/m), especially in manufacturing (-1.4%). There was also a fall in confidence indicators. The recent performance in these indicators is in line with signs of weak employment and manufacturing in the US. In terms of prices, the increase in the non-core sub-index led to an upswing in inflation which hit 4.3% in June. Even at this level, the lack of demand pressures and a favorable comparison effect in the final months of the year favor inflation coming in at the end of 2012 within the target variability band at the central bank. Nevertheless, we will need to watch the performance of prices in poultry products and maize given the recent bird flu outbreak in Jalisco and the drought in the US possibly leading to pressures, mainly temporary, on these markets. In terms of statements, the central bank has been very balanced regarding inflationary risks: downward for an output slowdown and upward due to devaluation or supply shocks.

In short, we believe **current inflation conditions and domestic growth, linked to uncertainty around the external scenario, are in line with a monetary pause at least for the remainder of the year**. However, we maintain a bias for a cut if economic activity sees a significant downturn.

- ### High market volatility in fixed income in Mexico set to continue

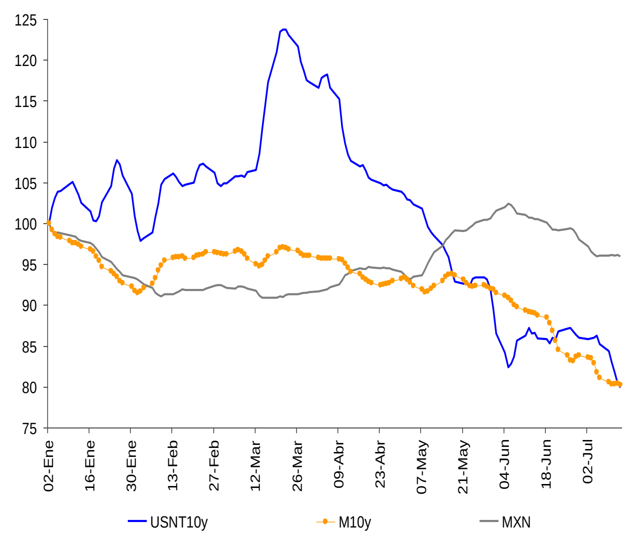
Sustained demand for bonds from overseas and all-time lows in US T-bill yields meant the M10Y rate closed 6bp lower over the week. In turn, the MXN saw high volatility and closed up 1%. With no important changes in the US and Europe, this performance is likely to continue.

Chart 1
Implicit monetary policy rate in IRS swap contracts



Source: BBVA Research, Valmer and Bloomberg

Chart 2
Weekly performance for the MXN, NT10Y and M10Y in 2012 (100=Jan 1, 2012, weekly average)



Source: BBVA Research and Bloomberg

Calendar: Indicators

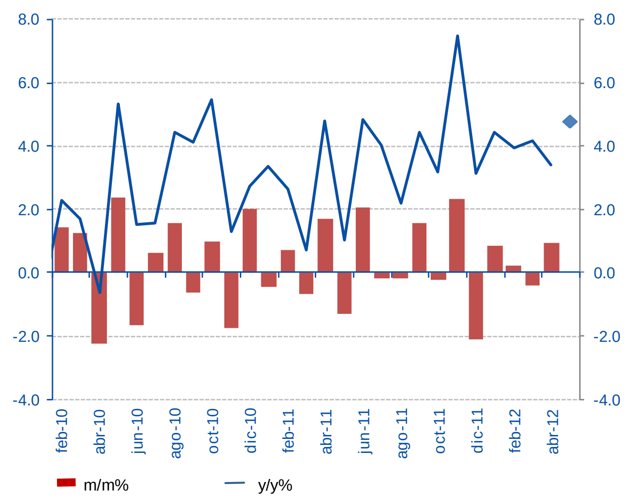
Retail sales (July 19)

Forecast: 0.0% m/m, 4.8% y/y	Consensus: N.A.	Previous: 0.9% m/m, 3.9% y/y

Retail sales in May continued to expand strongly compared to last year. Nonetheless, a standstill in monthly terms does not stand out. The job market continues to see buoyant, even increasing, growth of 0.5% for June which compares favorably with the 0.4% seen over the three previous months on average. Nevertheless, annual growth in real wages continues to be modest for workers insured in the IMSS and is even negative outside the formal market.

Job market figures for June will be released on July 20 with the percentage of unemployed, those in underemployment and those in work in critical conditions (those working less than they would like and those working many hours with relatively low income) being important. All these indicators will help calibrate the quality of jobs created, one of the keys for monitoring household consumer domestic demand potential.

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



Source: BBVA Research with INEGI and Bloomberg data

Markets

- ## Yield curve in Mexico sees high volatility

Mexico's yield curve saw high volatility during the week, with a negative start that inverted at the end of the week due to continued overseas demand and sustained record lows in US T-bill rates. The 10 year rate closed 6bp lower over the week, while the 20 and 30 year bonds fell 2 and 3bp respectively. This means that the curve remains flat in the mid-section despite major flattening in the long sections compared with the "*belly*" over previous days. We believe this performance may continue to dominate in coming weeks although we expect to see lower relative performance in the mid-section compared to long and short maturities.

- ## MXN strengthened 1% last week after trading in a wide range

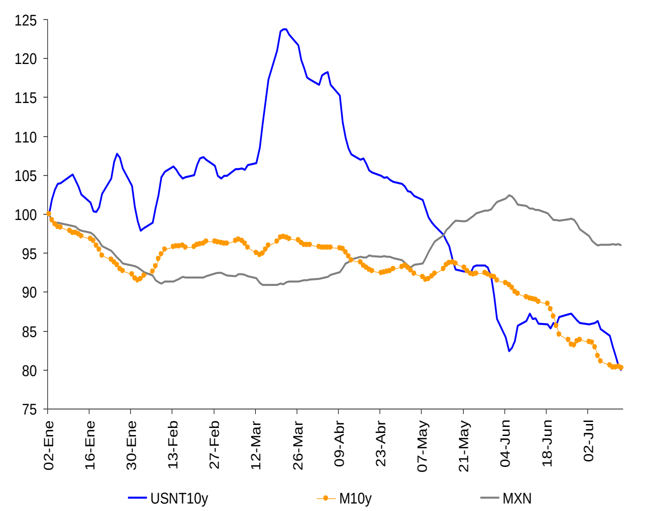
Volatility in most risk assets remains high with no short-term factors on the horizon to change this performance. In turn, the MXN remains highly sensitive to external factors in comparison to other currencies in the area. In this way, the size of moves in reaction to the series of positive news in a scenario of prevailing risks is no surprise. We believe this will continue to be the trend in the near future.

- ## Stock markets remain anxious due to global monetary signs

Equity markets awaited favorable news to realize advances over the week. This was seen on most major markets at the end of the week after the release of Chinese GDP growth in line with forecasts and better-than-expected corporate reports in the US (see chart JPM). Italy's debt downgrade by Moody's even moved into the background for markets.

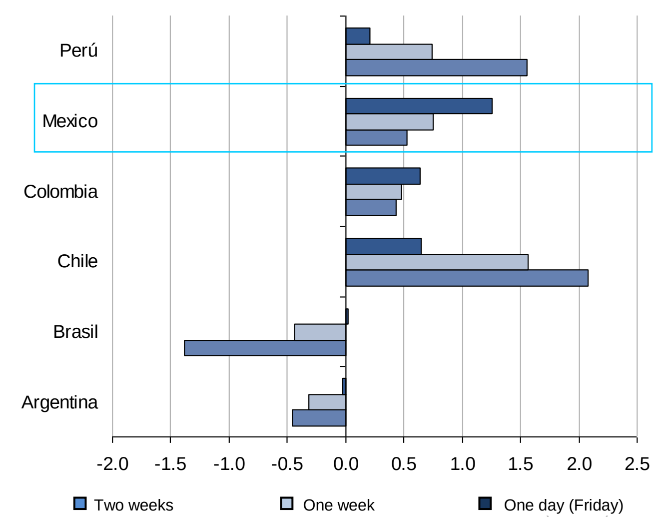
Markets will remain anxious for details on the macro situation, the EMU fiscal integration and the monetary bias for the main central banks. In this way, stock markets will focus on coming macroeconomic data in the US (industrial output, real estate, retail sales, etc.), Europe (ZEW and inflation) and Mexico's monetary policy decision. In addition, 92 corporate reports will be released in the US for 2Q12: the consensus forecasts an increase of 1.8% and 5.4% y/y in revenue and earnings per share. In Mexico, corporate revenue is expected to see 15% y/y growth and EBITDA 10.5%.

Chart 5
Weekly performance for the MXN, NT10Y and M10Y in 2012 (100=Jan 1, 2012, weekly average)



Source: Bloomberg and BBVA Research

Chart 6
Share Indices: changes (%)



Source: Bloomberg and BBVA Research

Technical Analysis

IPC

Source: BBVA, Bancomer, Bloomberg

The adjustment we expected in the IPC failed to materialize, despite the 6 lower sessions on the US market. In this upward scenario for the US, we see the IPC breaking down through the 40,000pts level as complicated. With the weekly close at a new all-time high above 40,000pts, we can consider targets at 41,000 and 41,500pts, a similar percentage to what we are forecasting for the Dow and S&P. Major issuers on the IPC (Amx, Walmex, Cemex) have started to come in above resistances which had not been hit for over a month. The scenario ruling out this upward perspective would be a return on the IPC to below 40,000pts.

Previous Rec. (9/7/12). The IPC adjustment may find an initial support at the 10-day rolling average at 39,800pts.

MXN

Source: BBVA, Bancomer, Bloomberg

The dollar was unable to maintain the break of the 10-day rolling average seen mid-week. With the return to levels below MXN13.40, the door is open for a new return to the MXN13.25 level. We believe it may again respect this floor.

Previous Rec. (July 9, 2012). The oscillating indicators suggest that this bounce could continue towards the next targets at MXN13.50 and MXN13.80.

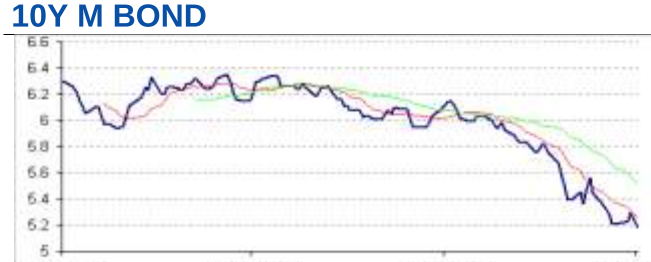
3Y M BOND

Source: BBVA, Bancomer, Bloomberg

3Y M BOND (yield): Weekly bounce but still to break up through the previous high. We believe it has marked a good floor at 4.65%.

Previous Rec. (9/7/12). Although it is close to very advance levels of over-selling, we do not see a strong support until 4.55%.

10Y M BOND



Source: BBVA, Bancomer, Bloomberg

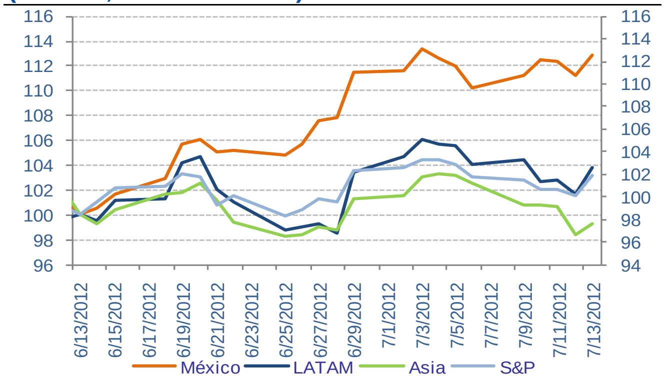
10Y M BOND (yield): A major downward trend remains in place without upswing attempts able to be maintained. Support levels at 5.2% and 5%. in order to be validated, any upswing attempt has to place it above the 10-day rolling average (5.3%).

Previous Rec. (9/7/12). This could give technical rebounds to 5.4% and subsequently 5.6%.

Markets

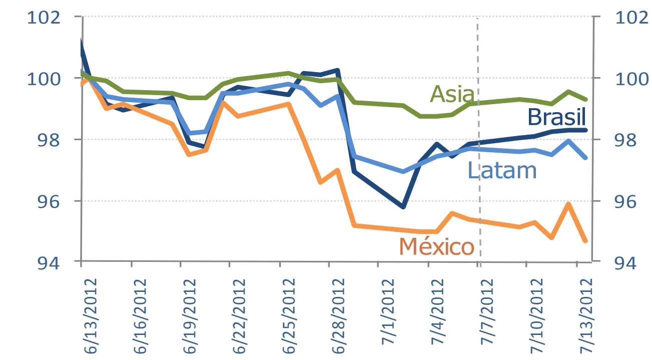
- **Better-than-expected US corporate reports, as well as speculation surrounding an increase in monetary stimulus in Europe and China, lead to gains on stock markets at the end of the week. The peso strengthened 1% over the week in a volatile environment.**

Chart 7
Stock Markets: MSCI Indices (June 13, 2012 index=100)



Source: Bloomberg & BBVA Research

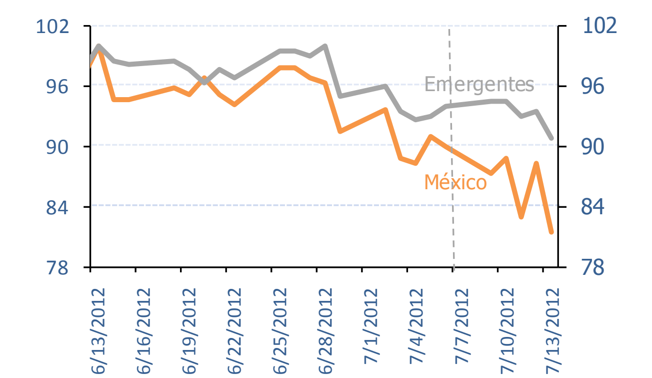
Chart 8
Foreign exchange: dollar exchange rates (June 13, 2012 index=100)



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

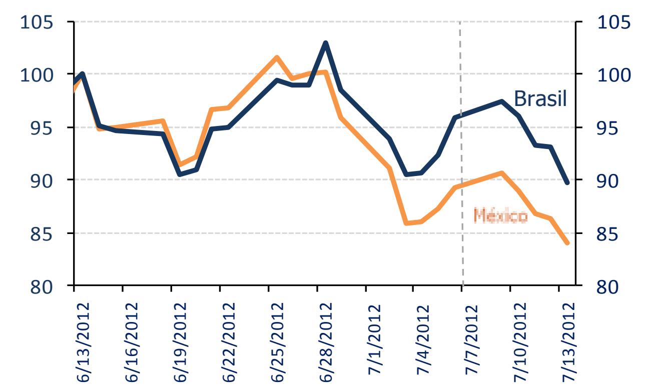
- **Fall in risk aversion over the week after the release more details on the Spanish banking bailout package.**

Chart 9
Risk: EMBI+ (June 13, 2012 index=100)



Source: Bloomberg & BBVA Research

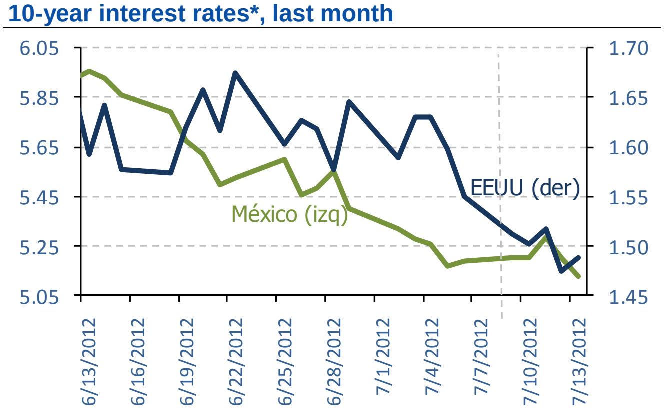
Chart 10
Risk: 5-year CDS (June 13, 2012 index=100)



Source: Bloomberg & BBVA Research

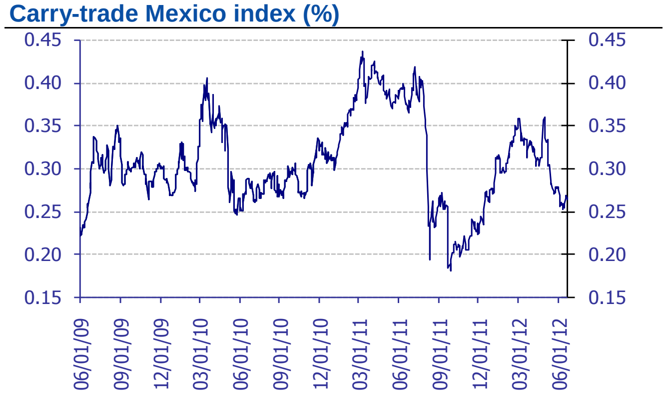
- **US rates fall over the week. Rates in Mexico fell, influenced by the performance of Treasury bonds and foreign investment inflows.**

Chart 11
10-year interest rates*, last month



Source: Bloomberg & BBVA Research

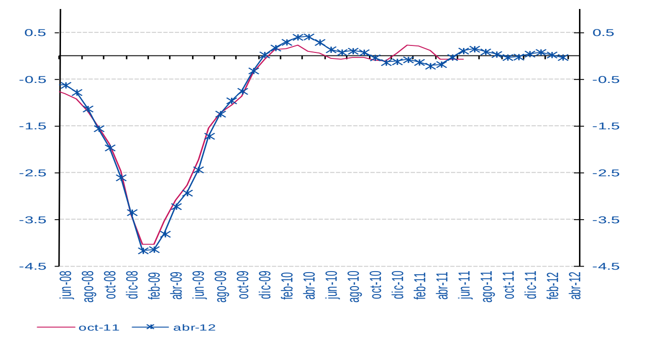
Chart 12
Carry-trade Mexico index (%)



Source: BBVA Research with data from Bloomberg

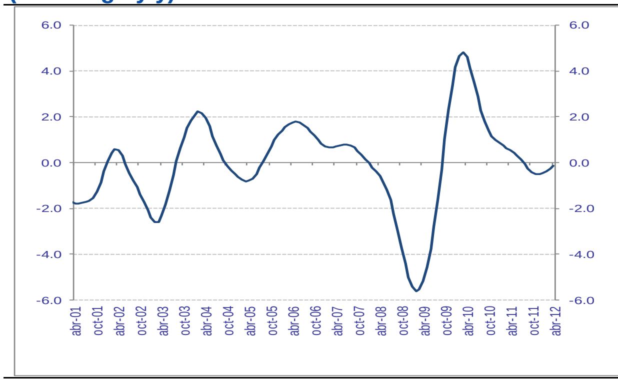
- **Output holds positive performance, situation indicators point to 2Q12 with quarterly rates around 0.7%.**

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.

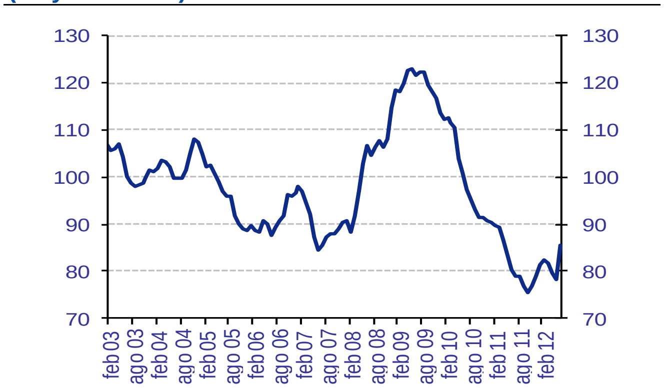
Chart 14
Advance Indicator of Activity, trend (% change y/y)



Source: INEGI

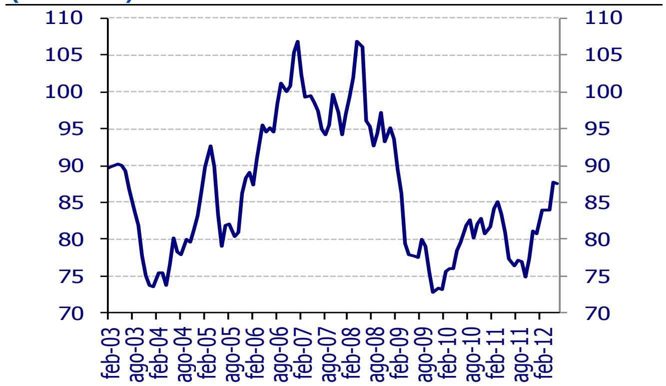
- **Inflation ceases downward surprises while output moved up.**

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.

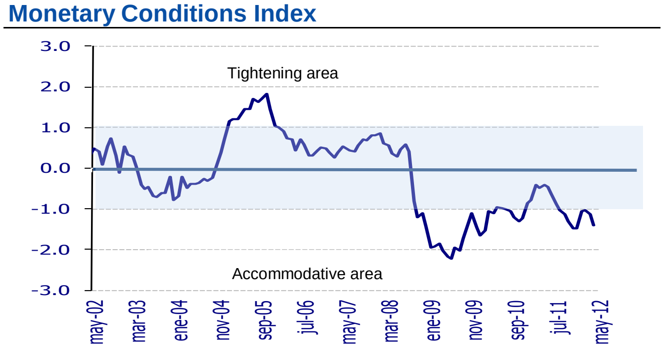
Chart 16
Activity Surprise Index (2002=100)



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.

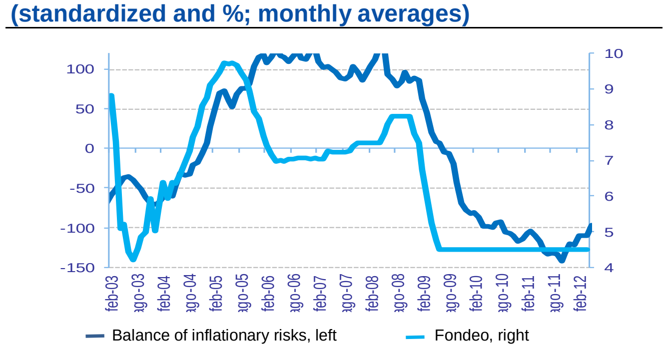
- **Monetary Conditions ease due to exchange rate depreciation in May and June**

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

Claudia Ceja
claudia.ceja@bbva.bancomer.com
+5255 5621 9715
Octavio Gutiérrez Engelmann
o.gutierrez3@bbva.bancomer.com
+5255 5621 9245
Iván Martínez
ivan.martinez.2@bbva.com

Pedro Uriz
pedro.uriz2@bbva.com

Julian Cubero
juan.cubero@bbva..com

Ociel Hernández
o.hernandez@bbva.bancomer.com
+5255 5621 9616
Rodrigo Ortega
r.ortega@bbva.bancomer.com
+52 55 5621 9701

Alejandro Fuentes Pérez
a.fuentes@bbva.bancomer.com
+52 55 5621 9705
Arnoldo López
arnoldo.lopez@bbva.com

Cecilia Posadas
c.posadas@bbva.com

BBVA RESEARCH | Av. Universidad 1200, Col. Xoco, Mexico 03339 D.F. | researchmexico@bbva.bancomer.com | www.bbvaresearch.com

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